RH-1-93 - Volume 8

Index for all transcripts / Indice des transcriptions d'audiences
Index for this transcript / Indice de la présente transcription d'audience
previous volume précédent
next volume suivant

NATIONAL ENERGY BOARD

OFFICE NATIONAL DE L'ÉNERGIE

Order No. RH-1-93

Ordonnance Nº RH-1-93

Foothills Pipe Lines Ltd

an Application by Foothills Pipe Lines Ltd. pursuant to Part IV of the National Energy Board Act and Part II of the Northern Pipeline Act.

Hearing held at
Audience tenue à

Calgary, Alberta

3 September 1993
3 septembre 1993

Volume 8

II

APPEARANCES

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C.K. Yates	Canadian Association of Petroleum Producers
A.Z. Menzies) D. Donaldson)	Alberta Natural Gas Company Ltd.
L.G. Keough	North Canadian Oils Limited; and Northern Border Pipeline Company
N. Mills	NOVA Corporation of Alberta
K.F. Miller	Pan-Alberta Gas Ltd.
M.A.K. Muir	ProGas Limited
M.J. Samuel	TransCanada PipeLines Limited
W.M. Moreland	Alberta Petroleum Marketing Commission
J. Syme) P. Noonan)	Board Counsel

III

INDEX

1309

--- Upon commencing at 8:30 a.m.

THE CHAIRMAN: Good morning, ladies and gentlemen.

Mr. Noonan, you have some preliminary matters, I understand.

MR. NOONAN: Yes, thank you, Mr. Chairman.

I would like to note, for the record, that my name is Peter Noonan. I have taken over from Mr. John Syme, who has left the Board for bigger and better things, we hope, in Ottawa.

Before we begin this morning, I wish to advise that I have canvassed counsel, and there are no undertakings or other preliminary matters that are still outstanding.

I do, however, wish to note that the Board itself has received a letter. It purports to be from the Department of National Defence, although there is no Warrant of Authority. I think that it, perhaps, might be a citizen's comments.

I do not intend to enter this as a formal exhibit, but it will go on to the official file of the Board, and I will leave it with the Clerk; and if anyone wishes to look at it during the course of the hearing today, they are welcome

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FHPL Arg.
(Lutes)

to do so.

Thank you, Mr. Chairman.

THE CHAIRMAN: Thank you, Mr. Noonan.

Mr. Lutes, you are ready to proceed. You are in good voice this morning, I assume.

MR. LUTES: I hope so, Mr. Chairman -- and we are ready to proceed.

ARGUMENT ON BEHALF OF FOOTHILLS PIPE LINES LTD.:

Introduction:

MR. LUTES: Mr. Chairman, the Foothills' Rate Case is largely centered on the important issue of the Company's capital structure.

Foothills firmly believes that it is imperative to adjust the equity component of its capital structure from 25 per cent to 35 per cent, in response to the significant changes in the Company's level of business risk and its requirement for improved financial flexibility.

This case is also, but perhaps less significantly, about rate of return on common equity; deferred income taxes; the rate of amortization for the special charge; the recovery of certain East Leg development costs incurred in association with the Can-Am project; Foothills'

1993 operating and maintenance budget; the applicability of the Incentive Rate of Return (IROR) scheme to Prebuild expansions; and the appropriateness of Foothills Zone 9 interruptible tolls.

PART I

CAPITAL STRUCTURE

We will deal, firstly, with the essential issue of capital structure. We will describe the historical basis for Foothills present capital structure, including the circumstances surrounding the original financing, and the effect of subsequent changes in United States gas markets and regulation which have fundamentally altered the security arrangements provided to support the original financing.

We will then address, in the context of Foothills' capital structure, a comparison of the relative business risks of Foothills and other gas pipelines regulated by this Board.

In addition, we have a few comments on the relationship of Foothills and Northern Border.

And finally, Mr. Chairman, again in the context of capital structure, we will speak to

Foothills' requirements for additional flexibility

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FHPL Arg.
(Lutes)

in financing the debt component of its capital structure.

Financing of the Original Prebuild

Let me turn, firstly, to the financing of the Prebuild.

In 1979, a series of steps were undertaken to initiate the Canadian portion of the Prebuild Project. These steps included the creation of a contractual and regulatory structure which was designed to assure a "minimum revenue stream" which would permit the Project to be financed.

The instruments created to assure the minimum revenue stream included: one, back-to-back contractual arrangements with U.S. interstate buyers, containing a clear requirement for the buyers to both take and pay for the gas; two, the ability, established by regulation, for these buyers to roll-in the higher cost of the Canadian gas into their system-wide supply; and three, assurances provided by U.S. Government and regulatory authorities that they would not take any action to specifically relieve the U.S. interstate buyers of their contractual obligations.

At the time the project was developed

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FHPL Arg.
(Lutes)

and financed, it was believed that this structure responded to the only perceived risks which the project might face: namely, the failure of the U.S. buyers to perform under their contracts and regulatory action which would relieve such buyers of their obligations.

Under this structure, the financing plan for the Prebuild was concluded with a 25 per cent equity component and a 75 per cent debt component. This plan was consistent with and part of the financing plan proposed for the Canadian portion of the Alaska Natural Gas Transportation System (ANGTS).

The adoption of the ANGTS capital structure for the financing of the Prebuild was based on the belief that deliveries of Alaska gas would commence in 1985. Notwithstanding the 1985 delivery date for Alaska gas, debt lenders to the Prebuild required that the project be financed on a stand-alone basis; that is, that the project financing would be self-liquidating over the life of the export authorizations. To secure the financing, assignments of all of the downstream sales contracts were made, firstly, to Foothills and then to its lenders.

1314
FHPL Arg.
(Lutes)

Changed Circumstances

The ability of the Prebuild contractual and regulatory structure to assure a minimum revenue stream was totally dependent on the continuation of the fully regulated gas markets that existed at the time the project was developed.

However, not only did those gas markets and the regulation of those markets change, they changed beyond all recognition. Nothing in the Prebuild contractual and regulatory structure insulated Foothills from the effect of these changes. As a result, gas moving on the Prebuild system today is exposed to all of the risks of the competitive marketplace.

As the Board is aware, Foothills and Pan-Alberta have responded to the changing marketplace with a considerable degree of success. In doing so, Foothills, its lenders, and its equity investors have absorbed a significant reduction in the quality of the security underpinning the Prebuild financing.

Mr. Chairman, given the fundamental changes which have occurred in the natural gas marketplace and the effect of these changes on the

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FHPL Arg.
(Lutes)

risks of Foothills, Foothills cannot understand the positions taken by APMC and CAPP in this proceeding, as expressed through the testimony of Mr. Peter Nettleton.

CAPP and APMC claim that the governmental and regulatory assurances of the United States have shielded Foothills from the business risks of its U.S. markets. In developing this assertion, Mr. Nettleton states that the Prebuild exports enjoy special protection under the Canada-U.S. Agreement.

Mr. Chairman, he is wrong. You need only read the Agreement to see that it pertains only to Alaskan and Northern Canadian natural gas. It does not address exports of Alberta gas through the Prebuild facilities.

Mr. Nettleton also asserts that the Prebuild project enjoys special protection under the waiver of law package passed by the Congress in 1981. Again, he is wrong.

The Prebuild Project had already been financed by the time the President signed the waiver law on December 15, 1981. More importantly, the waiver package does not apply to the Prebuild imports, and the FERC has confirmed that fact on at

least two occasions.

The record clearly demonstrates that CAPP and the APMC do not understand the nature, the limitations, and the effect of these assurances.

Mr. Chairman, we have pointed out throughout this proceeding that the existence of the Prebuild assurances did not, and will not, shield Foothills or its shippers from having to fully adapt to the fundamental changes which have occurred in North American gas markets over the last decade or those changes which may occur in the future.

The FERC assurances have been, and remain, limited. To illustrate: while in its series of market restructuring orders the FERC has honoured its commitments to maintain the Prebuild interstate buyer's obligation to purchase gas. At the same time, it has released the same interstate buyer's customers from their obligations, setting them free to buy gas elsewhere.

The end result of this is: the interstate buyers were simply not able to meet their obligations to the Prebuild. Therefore, the original Prebuild contracts, despite efforts by Pan-Alberta to respond to the market by amending

their take and price terms, could not be sustained. We have lost two of the original buyers, United and Panhandle, and are in the process of losing the third and last Eastern Leg buyer, Northern Natural.

Today's Prebuild arrangements are dramatically altered from those of 1979. Today, Foothills faces the full force of a competitive market.

As well, the FERC assurances do not protect the Prebuild Project from state regulatory risk. Indeed, you need only look to the situation in California today. The CPUC has placed pressure on SoCal and PITCO to reduce their Prebuild gas supply costs, $83 million of which have been characterized as "excess gas costs".

On the Western Leg, we believe that Pan-Alberta will eventually be involved in some restructuring of the PITCO arrangements. We also believe that, as with the Eastern Leg, such restructuring will inevitably impact on the credit support underpinning the Western Leg financing.

Mr. Chairman, you might well ask: To what extent is Foothills concerned about its future? Is it concerned about the marketability of

Alberta gas in the markets reached by its pipeline? Is it concerned about the supplies of gas to its pipeline and its ability to compete with other Canadian pipelines for such gas supplies?

Foothills is confident of its ability, and the ability of its shippers, to manage the future. Foothills is no more concerned about the risks of market and regulatory change than other Canadian gas transmission pipelines, having regard for the differences which exist between it and those pipelines.

The simple point is that there are real risks to the future of Foothills.

The common equity component is an essential element of Foothills ability to manage these future risks. We know from past events that the circumstances which prevail in gas markets today will change, and there will be times in the future when things will not be the same for us and our shippers as they appear today.

These are the risks of today's marketplace. They are certainly not the risks which the sponsors thought they were dealing with when the Prebuild project was conceived and developed.

COMPARATIVE BUSINESS RISKS

Let me now deal with Foothills business risks compared to the business risks of other pipelines regulated by the Board.

Market Risks

Foothills today believes that its market risks are greater than those of TransCanada PipeLines Limited (TCPL), Westcoast Energy Inc. (WEI), and Alberta Natural Gas Company Limited (ANG).

First, both TransCanada and Westcoast have large, stable domestic markets, representing approximately 50 per cent of their total system throughput. These domestic markets are subject to less competition from competing pipelines than the markets served by Foothills. As well, domestic markets hold considerably less political and regulatory risk than export markets.

As well, the export markets served by the Prebuild are more risky than the export markets served by any of ANG, TransCanada or Westcoast.

In its principal markets in the U.S. Midwest and California, Foothills faces significant competition as a result of the high level of excess pipeline capacity into those markets. The threats

to Foothills from such competition are more serious because the Prebuild is the high-cost transporter into every market that it serves.

ANG's existing markets in the Pacific Northwest and Northern California are served through pipeline facilities which are significantly depreciated in both Canada and the U.S. These facilities have a significant toll advantage over either the new expansion facilities or the existing Foothills' Western Leg tolls.

Westcoast has continued to maintain a significant share of its traditional export market in the Pacific Northwest. This market continues to grow, and any competition which may result from expansion shippers on PGT will be limited to those specific Northwest markets which can be accessed directly off the PGT system.

To the extent that PGT expansion gas has to make use of the Northwest Pipeline system, it would be at a cost disadvantage to gas moving through Westcoast.

With respect to TransCanada's export

markets, we believe that its U.S. northeast market is subject to less supply, price and transportation competition than almost any other U.S. export

market. TransCanada's transportation contracts into this market, as well as the sales contracts supporting it, are also relatively long term. In addition, with respect to the Midwest market, TransCanada has a transportation cost advantage over Foothills to that market.

Physical and Operating Risks

Mr. Chairman, let me turn briefly to a comparison of the physical and operating risks of Foothills and the other major gas pipelines regulated by the Board.

Foothills operates a single high-pressure pipeline on its Eastern Leg, compared to TransCanada's looped low-pressure pipeline system.

With respect to ANG, Foothills' Eastern Leg high-pressure system results in somewhat higher operating risks for Foothills, relative to ANG.

Foothills shares Dr. Sherwin's view that Westcoast's gathering and processing facilities expose it to higher operating risks than any of the other gas pipelines regulated by the Board, including Foothills.

Tariff Provisions

Mr. Chairman, Foothills accepts that

the demand charge abatement provisions of its Tariff provide it with somewhat more protection than does the Tariff of TransCanada. On the face of it, Foothills favourable Tariff provision may appear to offset some of the higher market and operating risks of Foothills compared to TransCanada. However, the risk-reducing impact of Foothills abatement provision, relative to TransCanada, may not be as great as it first appears. There is no evidence before you concerning the probability of TransCanada having to provide demand charge credits. It is hardly a risk for TransCanada to say in its Tariff that it will provide such a credit, if the probability of actually having to give such a credit is remote.

For example, we know TransCanada has a multi-looped system; it has multiple engines at each compressor station; its engineering design may be more conservative than Foothills; its critical unit outage design may be more conservative; it has access to storage at its market; and it has a mix of contracts that provide it with flexibility in terms of daily delivery obligations.

In short, Mr. Chairman, one cannot draw any conclusions about this matter on the basis of

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FHPL Arg.
(Lutes)

the Tariff provision alone. Further, there is no evidence on this record that would indicate that TransCanada, in its 30-odd years of operation, has ever had to provide a demand charge credit.

Conclusion on Comparative Risk

On balance, Foothills believes its operating and market risks make it more risky than both TransCanada and ANG, and that the effect of Foothills more favourable Tariff provisions conditions concerning abatement of demand charges do not alter that conclusion.

Foothills believes that its higher market risks are offset by Westcoast's higher operating risks, and that the overall risk profiles of Westcoast and Foothills are equal.

Northern Border

Mr. Chairman, before we leave this comparison of Foothills and other pipelines, we would like to draw your attention to one other matter.

In the context of the North American gas market in which Foothills operates, our business risks are, in many respects, similar to those to which Northern Border is exposed. In that regard, Northern Border continues to have recourse

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FHPL Arg.
(Lutes)

to some of the original interstate pipeline buyers for payment of its tolls. Foothills does not.

Notwithstanding this, Northern Border has a 35 per cent common equity ratio; it recovers normalized income taxes; and its rate of return on common equity is 12.75 per cent.

Financing Flexibility

This brings me to the last topic under the general heading of Capital Structure, which is the issue of financing flexibility.

I do not intend to summarize the extensive evidence which you have listened to over the past two weeks about financing. In considering Foothills' need for a capital structures which provides it with an appropriate degree of financing flexibility, the Board should have regard to all of the circumstances which existed when the existing loan arrangements were put in place in 1980, as well as all of the changes which have taken place since then.

The original financing arrangements have, in large part, been described to you in this argument. However, three other factors which affect financing flexibility need to be kept in mind.

Foothills' rate of return on equity in 1980 was approved at 16 per cent; its Tariff provided for the recovery of deferred income taxes; and Foothills depreciation rates were fixed at 4 per cent.

Today, not only have lenders experienced a significant erosion of their original security, but Foothills present rate of return on common equity has been reduced to 12 1/2 per cent; it no longer collects deferred income taxes; and its depreciation rate has been reduced to 2 per cent.

Mr. Chairman, we are today in a lending environment where the banks are less eager to make the type of loan they made to Foothills in 1980.

The original bank arrangement has served Foothills and its shippers well over the years. However, today, Mr. Chairman, Foothills is faced with the challenge of securing long-term financing for its Western Leg expansion. In the not-too-distant future, Foothills will commence discussions with the banks concerning an extension of the term of the existing loan arrangements.

Under those loan arrangements, as presently structured, the basket clause

depreciation provision is scheduled to commence on November 1, 1987 on the Eastern Leg and on November 1, 1999 on the Western Leg.

As things now stand, the negotiations with the banks will be conducted under circumstances where Foothills has no financing flexibility and against the background of today's equity return, depreciation rates, and income tax treatment, rather than those which existed in 1980.

Mr. Chairman, we concur with Dr. Sherwin that the primary consideration for the for the Board in determining an appropriate capital structure is business risk. Nevertheless, we submit to you that a relevant consideration for which you should have regard is the need to provide Foothills, today, with an appropriate degree of financing flexibility.

APMC/CAPP EVIDENCE ON BUSINESS RISK

Before concluding this question of capital structure, I would like to address a few remarks to you on the position taken by APMC and CAPP witnesses concerning Foothills' business risks.

We have already dealt extensively with

Mr. Nettleton's evidence concerning the assurances and his knowledge of Foothills' competitive circumstances.

Despite Mr. Nettleton's assertion that the Prebuild Project exists under some sort of Traveller's umbrella type of protection, we were, Mr. Chairman, somewhat astonished to here Mr. Nettleton's definition of business risk during this exchange with Mr. Syme.

"MR. NETTLETON: This would be the economic viability of Foothills versus the viability of these other pipeline companies. You boil that down to saying: the Ability of those pipeline companies to meet the requirements and contractual commitments by the shippers for transportation." (Tr. 1235)

Further, Mr. Chairman, Mr. Nettleton's lack of knowledge of the relative risk of other Canadian pipelines was clearly revealed during this exchange with you, concerning his assessment of the business risks of Westcoast.

"THE CHAIRMAN: In that regard, as I understand what you were saying -- and I am thinking of Westcoast's

situation, with its gas plants and gathering system, which I think Dr. Sherwin mentioned in his Written

Evidence -- don't you see a difference there, and perhaps in other characteristics?

MR. NETTLETON: It is a different characteristic, but I don't view it as being one of risk.

As you very well know, sir, the B.C.

gas is much drier and it is just an integral part of a transmission system. I don't believe the gas plant in B.C. presents a substantive risk to Westcoast." (Tr. 1301&1302).

Mr. Nettleton does not appear to be aware of the risks of Westcoast's extensive sour gas gathering system or of its three gas processing plants and sulphur plants. There is considerable historical experience of the existence of such risks. We did not find his evidence credible.

Turning to Dr. Waters, we submit that he provides no evidence on Foothills' business risks. Neither his letter of March 12, 1993, on which the Board based its interim toll order, nor

his evidence in this proceeding, is based on any analysis of Foothills' business risks.

In fact, in this case, Dr. Waters relies on Mr. Nettleton's assessment of business risks, which should best be characterized as superficial.

In short, Mr. Chairman, the only credible evidence in this proceeding on business risk is that provided by Foothills.

CONCLUSION - CAPITAL STRUCTURE

Mr. Chairman, in conclusion on this issue of the appropriate capital structure, we have addressed, firstly, the changes which have taken place in Foothills' business risks since 1980; secondly, we have addressed a comparison of Foothills' business risks to those of other major gas pipelines regulated by you; and finally, we have addressed the need for a capital structure which provides Foothills with the same degree of financial flexibility enjoyed by other major gas pipelines.

Mr. Chairman, we think now is the right time to bring Foothills' capital structure into line with its business risks and provide it with the financial flexibility it requires. We think it

is the right time for the following reasons:

1. Foothills is now completing expansions which will result in a substantial decline in tolls on both the Eastern and Western Leg;
2. the current interest rate environment makes this an appropriate time for Foothills to have access to alternative financial markets;
3. the restructuring of the Eastern Leg contracts will be completed this fall;
4. the need for Foothills to finance the Western Leg expansion and renegotiate the terms of its existing loan arrangement; and
5. the need to provide Foothills' Management with a strong and stable financial structure, which provides it with the flexibility to manage future change.

Finally, Mr. Chairman, Foothills does not believe that a gradualist approach to financing its common equity ratio is appropriate. As Dr. Sherwin said to you:

> "Your job is to give, as you have done before, every utility a reasonable return on a capital structure that reflects its risk." (Tr. 1014)

Mr. Chairman, Foothills requires a

capital structure today which is fully reflective of its business risks and which allows it to access capital under appropriate terms and conditions. Our lenders need to be confident that we have a stable and consistent capital structure, varying only as risk conditions change, so that when they commit their funds, they can be sure what the rules of the game are.

Accordingly, Mr. Chairman, we urge the Board to deal finally and conclusively with these matters in this proceeding.

PART II

RATE OF RETURN ON COMMON EQUITY

Let me now turn to the issue of appropriate rate of return on common equity.

Foothills believes that in today's environment, the Board should approve a return on common equity of 12.5 per cent, based on the evidence of Dr. Sherwin, Ms. McShane and Mrs. McLeod.

Dr. Waters, the APMC/CAPP expert

witness, recommends that the Board approve a return on equity in the range of 10 1/2 to 11 1/2 per cent.

The principles to be applied by the

Board in determining the fair rate of return are not in dispute. The return should permit Foothills: (1) to achieve a level of earnings comparable to that earned by other companies of similar risk; (2) to maintain its financial integrity; and (3) to permit the attraction of capital on reasonable terms.

These principles were applied by Foothills' expert witnesses through the application of three techniques of measurement: the Comparable Earnings Test; the Discounted Cash Flow Test; and the Risk Premium Test.

By comparison, Dr. Waters relies solely on the Risk Premium Test.

The Comparable Earnings Test is a measure of the "fairness" standard, which proceeds on the premise that utilities are entitled to a return commensurate with that achievable by competitive industrials of comparable risk to utilities, and as such the Comparable Earnings Test is consistent with the judicial standard governing these matters and which is set out by Mr. Justice Lamont of the Supreme Court of Canada in the 1992 Northwest Utilities case, wherein Mr. Justice Lamont stated, and I quote:

> "By a fair return is meant that the company will be allowed as large a return on the capital invested in its enterprise, which will be net to the company, as it would receive if it were investing the same amount in other securities possessing an attractiveness, stability and certainty equal to that of the company's enterprise."

The other two tests -- the DCF and Risk Premium techniques -- are measures of the cost of attracting capital. The application of techniques which measure the cost of attracting capital result in a bare-bones cost of capital; or, in other words, a measure of the returns required on the market value of their investments.

If a market-determined cost of attracting capital is applied to book equity, the market price of the stock will tend toward book value. Accordingly, Dr. Sherwin and Ms. McShane believe an adjustment for financing flexibility is required sufficient to achieve a market-to-book ratio of 115 per cent.

Mrs. McLeod (Ex. B-4, p. 45) makes a

similar adjustment to the investors' required rate of return of between 110 to 115 per cent to cover the impact of market pressure and flotation costs.

The recommendation of Foothills' expert witnesses in this proceeding can be summarized as follows:

	SHERWIN/McSHANE	McLEOD
Comparable Earnings	12.25-12.5%	12.5%
Discounted Cash Flow	12.6%	12.25-12.50%
Equity Risk Premium	12.8%	12.0-12.50%

Dr. Sherwin and Ms. McShane give 60 per cent weight to the Risk Premium Test, 30 per cent weight to Comparable Earnings, and 10 per cent weight to the DCF test, in arriving at their recommended return on common equity of 12.625 per cent.

Mrs. McLeod does not provide specific weightings for each of the three tests but does rely most heavily on the Risk Premium Test in concluding that the appropriate return on common equity for Foothills is at the upper end of the range of 12 to 12 1/2 per cent (Ex. B-10, p.3).

It should be borne in mind, Mr. Chairman, that all of the recommendations of Foothills' experts are based on the assumption that

the Board approves a common equity ratio of 35 per cent (McLeod Ex. B-4, p. 8) (Sherwin/McShane Ex. B-4, p.17).

By contrast, Dr. Waters' recommendation is based on a 25 per cent common equity ratio.

Dr. Waters takes issue with the growth estimates in both the Sherwin and McShane DCF-based risk premium studies. In the first test, Dr. Waters claims that the apparent downward trend in risk premiums is due to "upward" biased estimates of growth in earlier years and "more reasonable" -- but still upward biased -- estimates in more recent years.

Fundamentally, Dr. Waters' critique of the DCF-based studies assumes that investor expectations are governed by only one variable, the annual retained earnings growth -- which happens to produce the lowest growth rates.

Dr. Sherwin and Ms. McShane point out that investors look to more than one variable in forming their expectations. No informed investor relies on a single experienced growth rate to estimate the future.

Such a monolithic view contradicts all rational investor behaviour.

Dr. Waters criticizes the second Sherwin/McShane DCF-based test on the basis that it puts significant weight on longer-term investor experience as a measure of investor expectations.

Ms. McShane pointed out to Ms. Moreland that this is analagous to equity risk premium tests, such as that applied by Dr. Waters, which also rely heavily on long-term achieved stock market/bond return differentials.

The Board should note that the purpose of Dr. Sherwin and Ms. McShane's DCF-based studies was not only to estimate the level of the appropriate risk premium, but also the relationship between interest rates and risk premia. Therefore, the second test sought to explicitly remedy some of the possible distortions in risk premiums introduced by reliance on shorter-term achieved growth rates.

The reliance on a long-term average of retained earnings growth rates is based on the premise that the investors' longer-term growth expectations neither accelerated as rapidly as the experienced growth rates of the early years would suggest, nor had they declined as rapidly in the last few years, as suggested by the most recent

experience.

Stated differently, it is based on the premise that investors continue to have confidence in the fairness of the regulatory process and expect rising risk premiums to be reflected in the allowable returns, which should lead to rising retained earnings growth.

In summary, Mr. Chairman, there is significant empirical evidence before this Board of the inverse relationship between interest rates and risk premiums. This relationship has been reflected in the awards of this Board and other regulators in Canada.

Dr. Sherwin and Ms. McShane testified that a correlation of Long Canada rates and the risk premiums implicit in allowed returns showed a 0.6 per cent increase in the risk premium for each 1 per cent decline in interest rates.

In response to a question by Mr. Syme, Dr. Sherwin noted the problems inherent in both the DCF test and the Comparable Earnings Test under current circumstances, and suggested that, under those circumstances, the Board use the interest rate/risk premium relationship as a tool for determining the change in the cost of equity since

its most recent finding.

Flotation Costs

During this proceeding, the issue of providing Foothills with a flotation cost allowance above the "bare-bones" cost of attracting capital arose.

Mr. Chairman, capital was, and continues to be, committed to Foothills by its equity investors on the basis of a commitment by the Board that Foothills would be allowed an operating phase rate of return on equity equal to that of other pipelines of similar risk.

Mr. Chairman, that understanding was set out in the Board's Phase III November 1979 Reasons for Decision.

To deny Foothills a flotation cost allowance is to break that commitment and to unfairly limit the implicit market value of Foothills to book value, while allowing a higher degree of financial integrity to those pipelines which publicly raise common equity.

We do not think it should be of any concern to the Board, in establishing the fair return, how the Company raises its equity, because the fair return has regard to the alternatives

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FHPL Arg.
(Lutes)

which equity investors have for investment of their capital.

Since equity investors in Foothills have the same alternatives for their capital as equity investors in pipelines that raise equity in public markets, it follows that Foothills investors are entitled to earn a fair return.

Dr. Waters' Risk Premium Test

Let me turn to the risk premium evidence of Dr. Waters.

Dr. Waters' recommendation for Foothills' common equity return of 11 per cent is based solely on his risk premium study. Unlike Foothills' experts, Dr. Waters provides no alternative technique to check his risk premium results.

Mr. Chairman, you should consider carefully the reliability of Dr. Waters' evidence in these proceedings.

Firstly, we refer you to Exhibit B-15, which is the Table that Foothills put to Dr. Waters in cross-examination, comparing his market equity risk premiums in the Canadian Western Natural Gas 1992 case, the NOVA 1993 case, and this case.

You will note from that Table that as

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FHPL Arg.
(Lutes)

the numbers for his market equity risk premium change over time, so does Dr. Waters' risk premium technique.

The lack of consistency, not only in the raw data but in the analysis employed, creates serious doubts about the reliability of Dr. Waters' results.

The Table also shows that Dr. Waters made a large downward adjustment to the market equity risk premium in the Canadian Western Natural Gas case for the fact that bond investors failed to achieve their prospective returns in the 1950-1987 period.

Dr. Waters then admitted, under cross-examination, that over the last five years, equity investors in Canada have also failed to achieve their required returns. Dr. Waters makes no adjustment for the fact that equity investors have failed to achieve their required returns over the last five years.

Not only does he make no adjustment for the failure of equity investors to achieve their required returns, he continues to update his data, thereby further skewing his results downward.

This is evidenced by the fact that

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FHPL Arg.
(Lutes)

between the NOVA case in June of this year and this case, he again updated his market equity risk premia for 1992 results and reduced his market risk premium by a further 30 to 40 basis points.

In Exhibit B-16, we presented Dr. Waters with a Table entitled "Dr. Waters 'Do What I Say, Not What I Do'" return recommendation for Foothills Pipe Lines.

This table demonstrates without a doubt that Dr. Waters' equity risk premium recommendation is based on a target which Dr. Waters is attempting to achieve and is not a result which is derived from adherence to a consistently applied analytical process.

Mr. Chairman, Dr. Waters' adjustment for his investors' required rate of return of 25 to 50 basis points to account for "uncertainty" in financial markets also purportedly does double duty to provide Foothills with a cushion to enable it to maintain its financial integrity (Ex. C-1-6, p.4).

The "uncertainty" cushion has been around Dr. Waters' evidence for years, and you should wonder, in light of what appears to be a relatively stable current financial market, what it is all about.

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FHPL Arg.
(Lutes)

When all is said and done, Mr. Chairman, you should ask yourself very seriously whether Dr. Waters' 25 to 50 basis point cushion meets the fairness standard prescribed by Mr. Justice Lamont of the Supreme Court of Canada, which I quoted to you earlier.

In conclusion, Mr. Chairman, the only credible evidence in this case supports the conclusion in favour of a rate of return on common equity of 12 1/2 per cent.

PART III

DEFERRED INCOME TAXES

Let me now turn to the question of deferred income taxes.

Item 3 of the Board's List of Issues attached to Order RH-1-93 raises the question whether it is appropriate to draw down Foothills' deferred income taxes and, if so, to what extent and over what time period.

The CAPP policy evidence states that it is CAPP's intention to obtain further information through this hearing process, and then to have further discussions with Foothills concerning this matter before it makes a recommendation to the Board on this issue.

1343
FHPL Arg.
(Lutes)

CAPP anticipates that these discussions will take place prior to the end of this year, and after Foothills has raised this question of deferred income tax drawdown with its lenders.

It is Foothills' position that the question of the drawdown of its deferred taxes will have to be addressed by both Foothills' lenders and its equity investors. The appropriate time to discuss this matter with Foothills' lenders will be after the Board has rendered a decision in this case. Clearly, any discussion with the banks regarding this matter will be influenced by the decision in this case.

Foothills would be prepared, at this time, to undertake with the Board that, following the receipt of the Board's Decision in this proceeding, it will commence discussions as soon as possible with its bank and its equity investors. Thereafter, Foothills will arrange meetings with its shippers and other interested parties to discuss this matter. Foothills will, of course, keep the Board advised concerning progress.

PART IV

SPECIAL CHARGE AMORTIZATION

Let me now make a few comments on the

1344
FHPL Arg.
(Lutes)

issue of the amortization rate to the special charge, which is Issue 4 on the Board's List of Issues.

In 1982, the Board approved the inclusion in Foothills' cost of service of an amount calculated as the return on, and amortization of, approximately $124 million of Foothills' preliminary expenditures which had been incurred prior to December 31, 1981.

These preliminary expenditures did not then, and do not now, comprise any part of Foothills' rate base assets which are presently being depreciated at a 2 per cent annual rate.

The amortization rate approved by the Board for the special charge expenditures was 4 per cent, and the return was approved at Foothills' common equity rate, all to be recovered on a pre-tax basis.

Recovery of the special charge was initially approved for a term to 1988. The term of the recovery of the special charge has been extended on two subsequent occasions, and has now been extended to the year 2000.

CAPP's position on the special charge amortization rate is that the special charge is no

different than gas-plant-in-service and should therefore be subject to the same rate of amortization as rate base. However, the special charge, as Mr. MacPherson admitted (T. 1099 & 1100), is not the same as gas-plant-in-service and does not receive similar treatment.

The recovery of the special charge has always been subject to Board review from time to time, and there is no logical relationship between the amortization rate of the special charge and the depreciation rate for the long-life assets which comprise gas-plant-in-service.

Mr. Chairman, there has been no evidence advanced that would suggest any logical basis for altering the rate of amortization of the special charge. In November 1992, the Board approved an extension for the collection of the special charge to October 31, 2000. Absent any change in circumstances, Foothills' position is that the terms surrounding the special charge should not be altered.

PART V

CAN-AM PROJECT DEVELOPMENT COSTS

Mr. Chairman, Foothills is seeking approval from the Board to include in its Zone 6 and 9 rate base $765,000 of costs related to the CAN-AM Project. You have heard testimony from Foothills that the studies developed in connection with that Project were the initial step in the subsequent expansion of the Eastern Leg.

This project, and the related studies, were also used to stimulate interest among the shipper community and directly contributed to the expansion facilities eventually constructed.

To a large extent, had these studies not been undertaken in conjunction with the CAN-AM Project, they would nevertheless have been undertaken when the actual expansion occurred.

Mr. Chairman, I know of no precedent where a pipeline under your jurisdiction has been denied the recovery of expenditures related solely to the expansion of its existing pipeline system.

PART VI

OPERATING AND MAINTENANCE EXPENSES

Let me now turn to the 1993 operating and maintenance budgets.

On November 30, 1992, Foothills filed its 1993 Operating and Maintenance Expense Budgets with the Board. On August 13, 1993 Foothills updated that Budget.

Foothills has, through the Information Request process and through cross-examination, demonstrated to you that its amended Operating and Maintenance Budgets reflect an appropriate level of expenses required for the efficient and effective operation of the Foothills system during 1993.

PART VII

INCENTIVE RATE OF RETURN SCHEME (IROR) FOR PREBUILD EXPANSIONS

Mr. Chairman, Issue 5 of the Board's List of Issues attached to Order RH-1-93 request parties to consider whether the incentive rate of return scheme should be amended to exclude additions to the Prebuild portion of the pipeline.

Foothills' position is that to the extent such additions relate to the construction of facilities for the transportation of southern Canadian gas through Zones 6 through 9, the incentive rate of return scheme should not apply.

The original concept underlying the incentive rate of return scheme was to provide an incentive for cost control of a project which, because of its sheer scope, had a significant potential for cost overrun.

In such circumstances, both the

1348
FHPL Arg.
(Lutes)

Governments of Canada and the United States believed that there was a potential for significant cost efficiencies which could be achieved by implementation of an incentive rate of return scheme.

We do not believe that it was the intention of those Governments or of the Northern Pipeline Act that such a scheme would be applied, except in the context of a major construction project. The Board itself noted as much at page 3-1 of its November 1979 Reasons for Decision, and I quote:

> "This incentive rate resulting from good or bad cost control on the original pipeline construction should not apply to investments made years later on expansion of the system."

Accordingly, we are of the view that the incentive rate of return scheme should not apply to routine additions to Zones 6 through 9 for the purpose of transporting southern Canadian gas.

PART VIII

INTERRUPTIBLE TOLLS - ZONE 9

Finally, Mr. Chairman, I would like to address a few comments with respect to

1349
FHPL Arg.
(Lutes)

interruptible tolls on Zone 9.

Foothills' existing methodology for determination of interruptible tolls on Zone 9 was established pursuant to Board Order TG-10-87. In Foothills' view, there is no reason to alter the methodology previously approved by the Board. Interruptible tolls have not been addressed by any other party. Foothills believes its interruptible tolls should be approved to reflect the total Zone 9 cost of service which arises out of your decision in this application.

Mr. Chairman, that concludes our final submissions, unless there are any questions.

THE CHAIRMAN: Mr. Priddle has a question.

MR. PRIDDLE: Mr. Lutes, would you describe to me your purpose in alluding to some facts -- if you feel that they are facts in evidence before the Board -- about the regulatory treatment which Northern Border has received?

MR. LUTES: Mr. Chairman, our view of the world as it exists today is that Foothills competes in a North American gas market, and in competing in a North American gas market, we are exposed to the same risks, the same business risks,

1350
FHPL Arg.
(Lutes)

and to the same financial markets as United States pipelines.

Our concern is that as we go through time and our markets -- both the gas markets and the financial markets in North America -- become more integrated, that Foothills, in particular, and other Canadian gas pipelines in general, will need the same degree of financing flexibility and the same degree of financial strength to compete with and against the U.S. pipelines.

Frankly, we do not see ourselves as a Canadian pipeline, since all of the business which Foothills conducts is essentially in the United States market. In the long run, we think we have to have the same kind of financial flexibility that United States pipelines have.

MR. PRIDDLE: Can I be excused, then, Mr. Lutes, if I get the impression from that that you want some aspect of American regulatory treatment, or comparability to American regulatory treatment, for your clients. And are you looking for the best, the average, the worst?--and presumably the best.

And is that just on the financial side, or...?

1351
FHPL Arg.
(Lutes)

I am troubled by the concept that we should be influenced, in this decision, by what little evidence -- and I am not sure that it was tested evidence -- there is before us about the certain elements, selected elements, of regulatory treatment which Northern Border has had.

Can you understand that concern?

MR. LUTES: Mr. Priddle, I can understand your concern if your concern is that you are not satisfied that an evidentiary basis has been established for an appropriate comparison between Foothills and Northern Border, in this particular instance, in the same matter as I have asserted that there is no evidentiary basis for an appropriate conclusion with respect to the Tariff provisions between Foothills and TransCanada.

I can understand that and I am hard pressed to disagree with you. There has not been a complete record established concerning all of the regulatory treatment to which Northern Border may be subject.

But I did sense in your question that there was maybe a suggestion that there are obvious regulatory differences between the way pipelines in the United States are treated and the way that

1352
FHPL Arg.
(Lutes)

pipelines in Canada are treated.

I think that that is an observation which, for many years, has been a fair observation, except I would say that, with the moving forward under Order 636 and what appears to be a sense in the United States that full fixed/variable rate designs may be the way to go, and hopefully an enlightened FERC seeing the light at the end of the tunnel on rolled-in rates, regulation of the pipelines in the United States and Canada is gradually evolving towards a very common basis.

If one accepts that it is evolving towards that end, the only remaining difference that will exist is the high degree of competition to which the U.S. pipelines are exposed in their domestic markets, to which, of course, we would say Foothills is also exposed.

MR. PRIDDLE: Mr. Lutes, on that point, I thought I heard you, early on, saying that Northern Border had retained relationships with connecting interstate pipelines, and I think that that was intended to convey to us that that had moderated its risk.

I wonder if you could just go back over that.

1353
FHPL Arg.
(Lutes)

MR. LUTES: Mr. Chairman, in the original arrangements that were put in place starting north of the border, the underlying security for Foothills cost of service was based on a series of assignments of the downstream sales agreements.

If you took the United transaction, for example, there was a Gas Sales Agreement between Northwest Alasakan and United; and then moving upstream, there was a Sales Agreement between Pan-Alberta and Northwest Alasakan.

What was assigned to Foothills and then, upstream, to Foothills' lenders were the Gas Purchase Agreements.

So that Foothills' lenders security, if you will, were the take-and-pay provisions in those Gas Purchase Agreements assigned to them, and held by the banks.

On the south side of the border, United was also a shipper on Northern Border, as well as a purchaser.

I am stretching a bit, but I believe that that was also true for Northern Natural and Panhandle; they were shippers on Northern Border.

When the restructuring of the gas sales

arrangements took place with United, Foothills in effect -- because its only security was the gas sales arrangements -- lost the original security represented by United's balance sheet.

However, Northern Border also had United on a transportation agreement. I am not clear exactly how that was restructured, but Northern Border did manage to obtain residual recourse to both United and Panhandle, and presumably will have some recourse to Northern Natural -- which Foothills did not enjoy because it did not have transportation agreements with those entities. We only had the gas sales arrangements.

MR. PRIDDLE: That is a financial recourse, rather than a market recourse, you are suggesting, which Northern Border has or may have with those three companies?

MR. LUTES: Yes. As I understand it, they are no longer shippers on Northern Border but stand behind the obligations of those who have taken assignments of those transportation contracts. So in that sense, it is a guarantee of the performance of those transportation contracts.

MR. PRIDDLE: One last point, Mr. Lutes. Are you arguing that the reduced

1355
FHPL Arg.
(Lutes)

depreciation rate of Foothills, the 2 per cent depreciation rate, is an element of risk -- I presume compared to the previous arrangements?

MR. LUTES: Mr. Chairman, there are two aspects: the first aspect is that the lower depreciation rate affects the cashflow and results in somewhat less -- not significant, but somewhat less -- financial flexibility.

Conceptually, in the perfect model, the theory would be that if your depreciation rates are lower, you have therefore pushed out into the future the recovery of your capital, and pushing out into the future the recovery of capital exposes you to more future risks than would be present if you recovered your capital earlier.

So, in the larger sense, there is an increased risk from lower depreciation rates. However, I do not think that we view that as a significant element of this whole case that we are trying to make to you. But certainly, to the extent that we have pushed out the recovery of capital, it is a large risk.

MR. PRIDDLE: Do you see the 2 per cent rate as being with Foothills for an indefinite future?

1356
FHPL Arg.
(Lutes)

MR. LUTES: Mr. Chairman, as you know, the existing depreciation rates are driven by the requirements of the banks, under the loan agreements, for amortization of the loan.

I think I can safely say that we would hope that the renegotiation of the loan agreements, extending the basket clause, would involve a review of the depreciation rates, which are presently scheduled to increase to 3 per cent on November 1, 1996. I am absolutely certain that that would be a topic on the agenda for negotiation with the banks.

Whether Foothills will put forward a proposal to continue the 2 per cent depreciation rates indefinitely or not, I could not say. I do not think anybody has addressed that at this point.

MR. PRIDDLE: Very good. Thank you, Mr. Lutes.

MR. LUTES: Thank you, Mr. Priddle.

THE CHAIRMAN: Thank you, Mr. Lutes.

Mr. Yates, I believe you are next.

1357
CAPP Arg.
(Yates)

ARGUMENT ON BEHALF OF THE CANADIAN ASSOCIATION OF PETROLEUM PRODUCERS:

MR. YATES: Thank you, Mr. Chairman.

My notes have been given to the Court Reporters, with a request that the evidentiary references be incorporated into the record.

INTRODUCTION

This is a case about relativity. It is a case about relativity of risk. The relativity relates to dimensions of both time and space, because the principal issues that face the Board are these two:

1. What is the relative risk of Foothills in 1993, compared to what it was when the pipeline was last before the Board, in 1984 or 1986?

2. What is the relative risk of Foothills compared to other Canadian pipelines?

Relativity is the issue. Not any theory of relativity (Dr. Waters' anecdote notwithstanding), but judgment of relativity. And more importantly, it is your judgment of relativity.

1358
CAPP Arg.
(Yates)

You, the Board, have the very difficult task of taking the diametrically opposed opinions of the witnesses for Foothills and for CAPP and the APMC and then distilling your own assessment.

Mr. Pierce, Mr. Cameron, Mr. Reid, Mrs. McLeod and Dr. Sherwin can and do opine on the relative risk of Foothills, but they have no better basis upon which to do so than do Mr. Macnamara, Mr. Nettleton, Dr. Waters or Mr. MacMurchy. The opinions of all the witnesses are going to be influenced by their individual perspectives.

The opinions, however, all depend upon the facts. And it is therefore to the facts that the Board must look in reaching its decision in this case, and it is to the facts that the Board must look in determining whether to accept the opinions of the Foothills' witnesses or the CAPP and APMC witnesses.

It is the submission of CAPP that the facts support the opinions of Dr. Waters and Mr. Nettleton that the business risks of Foothills have declined since 1984, and that Foothills now faces the least risk of any time in its existence (Written Evidence of P. Nettleton, "Nettleton Evidence" Ex. C-1-5, p.2).

The facts support the position taken by Dr. Waters that Foothills' common equity ratio should remain at 25 per cent and that its rate of return on that common equity should be set in a range of 10 1/2 to 11 1/2 per cent (Written Evidence of W.R. Waters on Fair Rate of Return on behalf of CAPP and APMC,"Waters Evidence", Ex. C-1-6, p. 1 and 2).

The facts do not support the trepidation expressed by the Foothills' witnesses; nor, in my submission to you, do they provide any basis for an increase of 40 per cent in the Foothills' common equity ratio -- and here I am referring, of course, to the requested increase from 25 per cent to 35 per cent in the deemed common equity.

The facts do not support a return on equity of 13, 12-5/8ths, or 12-1/2.

The position of the Association has not been taken lightly, but only after consultation with knowledgeable consultants and amongst its members. CAPP, therefore, takes its positions in this case, not from the perspective of an adversary of Foothills, or an adversary of other pipelines, but from the position of tollpayers on the

Foothills' pipeline.

The Association recognizes, as

Mr. Macnamara, told you, that if the pipelines are not healthy, it is the producers that are the first to be impacted (6T1130).

The members of CAPP, as tollpayers, do not want to jeopardize the financial integrity of Foothills or cause tolls to increase (6T1113).

While the calumnies of Mr. Pierce became a little tiresome (see eg. 2T289; 4T640-641), at least Mr. Reid was prepared to recognize that the producers have consistently been supportive of Foothills (4T637; 4T640; 4T622). Producers have been prepared to accept lesser netbacks from sales through the Foothills' system than through other pipelines, while Foothills itself continued, year after year, to recover all of its costs and to achieve its allowed rate of return (7T1215L19).

We are in the new era of deregulation, where it is absolutely critical that Alberta natural gas have the ability to compete effectively in the evolving and increasingly competitive North American natural gas market (Written Evidence of APMC, Ex. C-24-4, p.2).

In this environment, it is even more important today than ever before that pipeline tolls be carefully scrutinized to ensure that they be at the lowest possible level that complies with the "just and reasonable" standard, and that level, in the considered submission of CAPP, would derive from the retention of a 25 per cent common equity ratio and from the setting of the return on equity at a level no higher than 11 per cent.

Let's look at the facts that support this position. Let's look at those facts firstly in the context of the relative risk of Foothills in 1993 and 1984. I call this the "that was then, this is now" comparison.

"THAT WAS THEN, THIS IS NOW"

We spent a lot of time in this hearing talking about history. There was a reason for that. The reason was that Foothills, in support of its request for a 40 per cent increase in its return on common equity, took, and continues to assert, the position that its business risk has dramatically increased over time.

That position, Mr. Chairman and Members, is simply not supported by the facts, as became clear as I discussed the history of

CAPP Arg.
(Yates)

Foothills with the Business Risk and Policy Panel.

The template that I used for that cross-examination was the document that became Exhibit C-1-13, which was the Pan-Alberta Gas Overview of the Prebuild Project.

I suggest to you that Exhibit C-1-13 is a valuable document -- not only because it was prepared by a major shipper on the Foothills' system, and not because it was prepared by a company of which Mr. Pierce is, and was, the Chairman, and of which Mr. Reid and Mr. Cameron are former employees, but because it provides a clear and concise precis of the events that Foothills suggests have increased its risk and that CAPP suggests have had the opposite effect.

The variation of business risk of Foothills over time can be shown through a series of snapshots. The first snapshot is 1977. In July of that year, the Board issued its Reasons for Decision on Northern Pipelines that gave Foothills the go-ahead over the Arctic Gas Pipeline consortium.

In the hearing, Foothills had proposed a 75/25 debt-equity ratio (NEB Reasons for Decision Northern Pipelines, Volume 2, June 1977 ("Northern

CAPP Arg.
(Yates)

Pipelines Decision), page 4-142 and 4-143; 4T704).

One of the reasons for proposing the 75/25 was to keep the tolls down and limit the burden borne by shippers through the cost of equity and associated income tax (Northern Pipelines Decision, page 4-143; 4T705).

The Board accepted the Foothills proposal, believing that it reflected the probable views of prospective lenders that 25 per cent would be required (Northern Piplelines Decision, page 4-143).

Contrary to the assertion of Mrs. McLeod (Prepared Evidence of M.T. McLeod, June 1993, Exhibit B-4, pages 21-22), a bond rating of Single-A was not then identified by the project sponsors as a key building block for the project. At least Foothills did not see it as important enough to provide any evidence in that hearing regarding the possibility of seeking a bond rating or whether a bond rating might be available to it

(4T714-15).

In September of 1977, an agreement was entered into between Canada and the United States on principles applicable to a northern natural gas pipeline (Exhibit C-1-13, page 1; 2T250), and the

President of the United States issued a decision which suggested that it would be beneficial to the United States for Canada to authorize additional exports of Canadian gas in order to permit early construction of the ANGTS (See Exhibit C-1-13, page 1; 2T250-251).

The next snapshot is 1979. The Board issued a decision on Foothills' tolls (NEB Reasons for Decision In the Matter of Phase III of a Public Hearing Respecting Tariffs and Tolls to be Charged, the Financing of the Pipeline, and Other Related Matters of Foothills Pipe Lines (Yukon) Ltd., November 1979 ("1979 Decision").

In that Decision, the Board found that Foothills and TransCanada PipeLines were of comparable risk Prepared Evidence of M.T. McLeod ("McLeod Evidence"), Exhibit B-4, page 14). The physical supply and market risks of Foothills were greater than TransCanada, but were substantially offset by the contemplated tariff provision. The Board found that the Foothills Tariff reduced the level of financial risk to less than that inherent in the capital structure of TransCanada (1979 Decision, page 3-31), and the Board found that a capital structure based on 75 per cent debt and 25

per cent equity would approximate what it referred to as an optimal capital structure for Foothills, being -- to use the phrase used by the Board, and I quote -- "one which will result in the lowest cost of service to customers" (1979 Decision, page 3-33).

The next snapshot is 1984, the last time Foothills had an oral rates hearing.

Mrs. McLeod was a witness. So were Dr. Sherwin and Dr. Waters.

What had happened by then? Foothills had been constructed, with the Western Leg commencing service in 1981 (Nettleton Evidence, Exhibit C-1-5, page 1). Within four months after the formal commencement of service on the Eastern Leg, United Gas Pipeline had declared force majeure and had asserted that it was relieved of its minimum purchase obligations under the Prebuild (agreements Exhibit C-1-13, page 16; 2T294).

A settlement had to be negotiated, and it involved dramatic reductions in the minimum contract volumes, not only of United but of other Prebuild customers (See 4T721).

By December 1983, when the Federal Energy Regulatory Commission approved the

1366
CAPP Arg.
(Yates)

settlement (Exhibit C-1-13, page 39) it was, in my submission, abundantly clear that the original premise of Foothills, that it could rely on significant pipeline companies to honour their contracts and provide the financial support for the Prebuild, was a premise that was so badly flawed as to be unreliable.

The load factor in 1982 had been 48 per cent on the Eastern Leg and 66 per cent on the Western Leg. It was worse by 1984, when it was 37 and 52, respectively (Nettleton Evidence, Exhibit C-1-5, pages 11-12).

Mrs. McLeod gave evidence in the 1984 proceeding that the decline in demand for natural gas in the United States and the proven unreliability of the tariff meant that Foothills risk had increased since 1979 (4T718AR).

Dr. Waters in that case effectively agreed. He recommended an increment of 35 to 60 basis points because of the uncertainty regarding the long-term viability of the Foothills system (NEB Reasons for Decision In the Matter of the Application under Part IV of the National Energy Board Act and Part II of the Northern Pipeline Act (Toll Application) of Foothills Pipe Lines (Yukon)

1367
CAPP Arg.
(Yates)

Ltd., September 1984, (RH-3-84 Decision) page 23).

In that hearing, Foothills made no request to increase its common equity ratio from 25 per cent. Mrs. McLeod expressed the view that Foothills would not be financeable in 1984 at 75/25, but the Board was not asked to deal with the capital structure issue.

The next snapshot is 1986. In that year, the Board decided to review Foothills rate of return having regard to trends in interest and inflation rates. Dr. Waters provided evidence in which he indicated that Foothills risks warranted an increment of 100 basis points over the return applicable for long-established gas pipelines (Exhibit B-17).

This, in my submission, was not a surprising conclusion, bearing in mind what the facts were in August of 1986 (7T1209).

In July of 1985, United once again claimed force majeure (C-1-13, page 35), and it had ceased purchasing its required minimum Prebuild volumes.

Negotiations were ongoing, and Pan-Alberta was on the verge of initiating formal arbitration proceedings against United and

Northwest Alasakan before the International Chamber of Commerce Court of Arbitration (Exhibit C-1-13, page 35).

The Interim Settlement had not been concluded, and the load factor on the Eastern Leg was 25 per cent (Nettleton Evidence, Exhibit C-1-5, page 12).

Cut to 1993, the last snapshot:

-- Deregulation of natural gas markets and prices is a fact on both sides of the border. Natural gas is being sold competetively in markets throughout North America.

-- The United problem has been resolved, with United exiting from the scene and being replaced initially by NATGAS and, later, PAG-US.

-- Load factors are up dramatically on the Eastern Leg, while the Western Leg throughput has been sustained (Exhibit C-1-5, pages 11 and 12).

-- Unit costs of the Prebuild have decreased significantly due to increased load factors, reduced depreciation, and the switch to flow-through tax accounting (Nettleton

Evidence, Exhibit C-1-5, pages 9 and 10). Northern Border's unit costs have also dropped dramatically (Exhibit C-1-5, page 13, A27).

-- There are more shippers on Foothills, a fact that lessens the risk of both supply failure and market failure (2T330).

-- The terms of the transportation contracts are longer (2T322-323; 3T527).

-- Shippers are in a position to access significant short-term interruptible spot markets, as well as longer-term firm service arrangements in the United States.

-- Shippers have access to virtually every state in the Lower 48 through exchanges off Northern Border (4T562).

-- The Prebuild maintains the exemption from Order 380 granted in 1984 -- and you will recall that Order 380 had precluded minimum purchase obligations by pipelines (2T292).

-- The Prebuild had been exempted, in 1988, from FERC Order 256, which precluded pass-through of demand charges by other Canadian pipelines (2T297-299).

-- Order 636-A has reaffirmed the U.S.

Government commitments to the ANGTS (2T306).

-- Prebuild contracts had been amended and were approved by the ERA which made specific reference to the uniqueness of the Prebuild as far as the ANGTS, and the commitment of Canadian and U.S. Governments to the ANGTS (2T299-302).

-- President Reagan, in 1988, reaffirmed the support of the United States for the special regulatory treatment of the Prebuild portion of the ANGTS, including the minimum revenue stream guarantees (Exhibit C-1-13 page 14 and Appendix H; 2T314).

-- The basket clause has been extended three or four times (3T411) and its potential impact has been reduced through depreciation, but it is not expected to be triggered (4T618-619). The basket clause remains a safety valve that Foothills has and other pipelines do not.

-- Foothills renegotiated its financing in 1990 and has since experienced reduced costs of debt (1T133-134; B-14, page 3, No. 6). The spreads are less.

-- And finally, Foothills has, in every year since its inception, achieved its allowed

rate of return (7T1215).

That, in my submission, gentlemen, is a

crytal clear snapshot of a pipeline that is healthier now than it has ever been. The 1993 snapshot shows no risks looming in the background, as were clearly present in the 1984 and 1986 photos. In 1993, Foothills, like other Canadian pipelines, must compete in the deregulated marketplace, but it faces the risks of competition with the additional shields of government and regulatory assurances that are unique to the ANGTS.

Foothills seeks to make much of the events that occurred between 1984 and now, arguing that those events are evidence of increases in risk.

While Foothills is to be commended for the efforts that it expended -- not alone, but in conjunction with producers, shippers and governments -- in the successful management of the difficult changes from regulated to deregulated environments, those efforts, and that commendation, do not amount to increased risk. All pipelines were struggling with the move to deregulation throughout this time frame, and no pipeline, other

1372
CAPP Arg.
(Yates)

than Foothills, has a protective umbrella of United States governmental and regulatory protection.

I think, Mr. Chairman and Members, it is worth looking at some of the wording -- as, in my submission, it could hardly have been more clear in several instances.

(1) When FERC issued Order 380, which established a generic rule relating to the recovery of variable costs through the minimum commodity bill provisions of pipeline tariffs, Pan-Alberta and Foothills filed a joint application for re-hearing, in which they sought reassurance in respect of the tariff and contractual structure which supported the minimum revenue stream established and guaranteed for the Prebuild Project in 1980 (Exhibit C-1-13, pages 17, 18; 2T291-292).

This Board wrote to FERC, and this Board said, and I quote:

> "Order 380 could constitute a breach of the U.S. Government commitments upon which the National Energy Board and the Canadian Government relied in 1980." (Exhibit C-1-13, page 19).

Order 380-A unequivocally declared that the rule was not intended to apply, and in fact did

1373
CAPP Arg.
(Yates)

not apply, to the tariffs underpinning the Prebuild project.

I think it is useful to look at what FERC said in Order 380-A, and it was this:

> "The ANGTS is a unique international project whose ultimate success has always rested on a framework of mutual trust and cooperation between the Governments of the United States and Canada. It is abundantly clear that the assurances made by the Commission, the Congress, and the President collectively comprise a commitment to protect the stream of revenue underpinning the financing of the Canadian segment of the ANGTS, that the Government of Canada relied on those assurances, and that any subsequent action that could adversely affect that stream of revenue would constitute a breach of faith in our nation's relationship with Canada. Accordingly, the Commission confirms that Order No. 380 was not intended to, and does not in fact, apply to the stream of the

1374
CAPP Arg.
(Yates)

> revenue defined in the orders issued by the Commission authorizing the instruction and operation of the 'prebuilt' portions of the U.S. segments of the ANGTS." (Exhibit C-1-13, pages 20-21; 2T295).

What could be more clear in showing that Foothills is considered to be special by that regulator?

(2) In December 1986, FERC's Opinion 256 restricted the flow of Canadian demand charges in the rates of U.S. pipelines. But again, on re-hearing, FERC exempted the Prebuild. And the words it used were, and I quote:

> "We do not in intend to depart from previous orders of the Commission regarding the assurances for the revenue stream of the ANGTS Prebuild

Project."

Both 380-A and 256-A were confirmed on review by the Court of Appeal for the District of Columbia Circuit (Exhibit C-1-13, pages 31-32; Exhibit C-1-13, page 21).

(3) The same sort of wording is seen in the consistent and repeated approvals of the ERA

1375
CAPP Arg.
(Yates)

and FERC of amendments to the Prebuild contracts. Those amendments have taken place to bring the Prebuild into the age of deregulation (Exhibit C-1-13, page 26).

In 1984, the ERA approved contractual amendments, extended the Prebuild import authorization until October 31, 2002 on the Eastern Leg and October 31, 2001 on the Western Leg. And it said that it, and I quote:

> "...took into account the uniqueness of the Prebuild as part of the ANGTS, and the commitments of the Canadian and U.S. Governments to the ANGTS."

In 1987, the term of the sale on the Western Leg was extended for 12 years, to 2012. Its approval, in June of 1988, by the NEB received a strong letter of support from the California Public Utilities Commission (Exhibit C-1-13, page 33 and Appendix G). The extension was approved by FERC and the ERA, and again the words are noteworthy, and I quote:

> "The requested extension of Northwest Alasakan's import arrangements supports the continuing commitment of the U.S. to the ANGTS..."

1376
CAPP Arg.
(Yates)

And again:

> "Commitment to the ANGTS Project and the relationship of the prebuild to the ANGTS is evidenced by international agreements between the Governments of United States and Canada, U.S. legislation, the formal support of two Presidents, and U.S. regulatory decisions including FERC Order 380 et seq. Moreover, ANGTA remains legally binding and the Presidential finding of September 12, 1988 reaffirmed the commitment of the U.S. Government to the ANGTS and to the special regulatory treatment of the prebuild." (Exhibit

C-1-13, page 34).

And in 1989, when the FERC approved settlement by which NATGAS replaced United, some more words arose, and again I quote:

"Until such time that the United States commitments to the prebuild portions of the ANGTS are deemed satisfied, any Commission action that jeopardizes the current revenue stream would violate Section 9(d) of the

ANGTA."

Again a quote:

"The investment and financing made for ANGTS is large and a large portion of that investment remains yet to be recovered."

And finally:

"At this time the supply and market circumstances underlying the 1980 decision are substantially changed.

However, the international and financial circumstances remain nearly the same." (Exhibit C-1-13, pages 40-41).

It is true, as the Foothills witnesses were fond of saying, that the FERC has not written a cheque to Foothills (2T249). It is equally true that Foothills has continued to achieve complete cost recovery and its allowed return in an environment of an increasing level of assurances from Canadian and United States regulators and the United States Government.

Foothills has an advantage that it does not share with any other Canadian export pipeline. The government and regulatory assurances have been

tested repeatedly since 1984 and have been found to be reliable. They have stood the test of time.

It is no small wonder, then, that Foothills cost of financing has declined in the same timeframe.

Mrs. McLeod said in 1984 -- and I referred to this earlier -- that, in her opinion, Foothills would not be financeable at 75/25.

That opinion has proven to be wrong.

Foothills has not only achieved a lower cost of debt since 1984 (Exhibit B-14, page 3, No. 6; 1T129-134), it has succeeded in refinancing the original facility in 1990 (1T133-34), it has negotiated the ability to issue commercial paper, it has financed $122 million expansion in 1992 (1T99ff), and it has utilized the creditworthiness of the Foothills companies to borrow a large amount of funds for a tax shelter investment (1T60-92).

A major tenet of Foothills' position in this Hearing is that increased business risk leads to higher financing costs. The facts and evidence in this proceeding show that thesis to be proven through its corollary; that is, that lower business risk should result, and has resulted, in lower debt costs.

1379
CAPP Arg.
(Yates)

The evidence of Mr. Dooley is that the spreads on Foothills' loans are smaller in 1993 than they were in 1982. The spreads became less when the loans were renegotiated in 1990 (1T129).

The spreads are the banker's measure of risk. The higher the spread, the riskier the bank perceives the loan to be.

The fact that Foothills was able to renegotiate its loans in 1990 and reduce the spreads over time is, in my submission, indicative that the perception of the banks is that Foothills has become less risky.

The same phenomenon is observable in respect to the commercial paper of Foothills. It is Mr. Dooley's Evidence that the ability of a corporation to issue commercial paper is an indication that it is a stronger credit than a corporation which cannot issue commercial paper (1T131).

Foothills did not have the ability to issue commercial paper until it negotiated that provision with the banks. And in fact, it did not actually access the commercial paper market until 1990 (Exhibit B-14, page 2, No. 2), after United had been replaced as a Foothills customer by

1380
CAPP Arg.
(Yates)

PAG-US. The renegotiation in 1990 resulted in lower rates for bankers acceptances (1T130).

It is also in this context that the 1992 loan to invest in a tax shelter should be viewed. Foothills tells you that the loan is a non-utility item (1T62), that it was made on the credit of the debentures issued by the Joint Exploration Company, and that it is not relevant to this issue or to the tax drawdown issue.

The fact is, however, that Foothills is a utility. The Foothills group of companies has a rather bizarre capital structure which came about for specific reasons, but the Foothills assets are utility assets. The fact is that a $150 million loan was achieved by the Foothills group of companies.

In the submission of CAPP, when all the explanations and obfuscations are swept aside, what is left is the revelation of easy access by the Foothills group of companies to a significant level of funds. The fact that Foothills can do this kind of deal suggests that its concerns about the financeability and the refinanceability of its pipeline assets amount to nothing more than crocodile tears.

1381
CAPP Arg.
(Yates)

The summary on the "that was then, this is now" issue, Mr. Chairman, is simply this: Foothills may tell you that, in their opinion, their business risk has increased. The facts tell you that it has not. The facts tell you that in 1993, Foothills -- which Mr. Pierce described as "terminally ill" in 1983 (3T410) -- in 1993 Foothills is full, has longer-term contracts than it had before, has lower tolls, is more competitive, and can borrow money at lower costs than it could before.

The government and regulatory assurances have been tested and proven. These are halcyon days for Foothills. They are not days fraught with greater risk but, quite the contrary, are the days of the least risk ever.
"THAT IS THEM, THIS IS US".

The second issue of relativity relates to the risk of Foothills by comparison to other pipeline companies. I call this the "that is them, this is us" comparison.

Foothills would have the Board conclude that its relative risk is comparable to Westcoast which, not coincidentally, has a 35 per cent common equity ratio. (See eg. 6T1015ff.)

1382
CAPP Arg.
(Yates)

The views expressed by the witnesses for CAPP and the APMC are, not surprisingly, not the same as those of Dr. Sherwin and Mrs. McLeod on this issue. Mr. Nettleton testified that the business risk of Foothills is less than TransCanada, ANG, NOVA or Westcoast, (Nettleton Evidence, Exhibit C-1-5, page 13; 7T1235-1239) and less than virtually any other pipeline subject to regulation by the National Energy Board.

Dr. Waters provided a lengthy dissertation -- in response to you, Mr. Priddle -- on the comparative situations of TransCanada and Foothills in the context of both capital structure and return on equity.

I will return to that topic in a few moments. Right now I would like to compare Foothills to Trans Quebec & Maritimes Pipeline, which is the only other pipeline regulated by the National Energy Board that presently has a deemed common equity of 25 per cent.

I do this, Mr. Chairman and Members, because the similarities of the two pipelines are quite remarkable:

-- Both pipelines started their lives as what Mr. Nettleton calls mandated pipelines,

meaning that they were supported by the governments of the day.

I have already talked about the United States and Canadian governments' support for Foothills. It is equally clear, from the decisions of this Board on TQM, that that pipeline was also a creature of government policy. (See eg. National Energy Board Reasons for Decision TransCanada PipeLines Limited Application dated 14 July 1986 for new tolls effective 1 January 1987, RH-3-86, May 1987 ("RH-3-86 Decision"), page 56).

-- Both pipelines are sponsored by other pipelines. NOVA and Westcoast are the shareholders of Foothills. NOVA and TCPL are the sponsors of TQM. (5T890-892.) In each case, the sponsoring companies enjoy the fruits of so-called double leverage. (5T904-907.)

-- Both pipelines have received regulatory protection of their tariff structure in reliance upon governmental assurances.

Again, I have already talked about FERC Order 380 and Opinion 256 in the context of Foothills. The comparative situation for TQM

is in the RH-3-86 Decision of this Board, when the Board rejected producer proposals that the rolling of the TQM cost of service into the TCPL revenue requirement should cease.

The Board provided specific recognition in that decision that the rolling-in of TQM's tolls was, and I quote:

> "... Established in the light of past economic, political and investment decisions made to achieve objectives which at the time were developed in the public interest of the country."
> (RH-3-86 Decision, page 56)

-- TQM's tolls are rolled-in to the tolls of TransCanada and are recovered from all shippers on the TransCanada system. In the case of Foothills, almost 50 per cent of its cost of service is in Zone 6 (Exhibit A-12); and since July 1989, the only shipper on Zone 6 has been NOVA, and Zone 6 tolls are rolled-in to the NOVA cost of service and are paid by all of NOVA's shippers (3T375-380).

In the view of Mrs. McLeod, this rolling-in of costs of one pipeline into the

tolls of another effectively equates the business risk of the two. And this means that, in Mrs. McLeod's view, TQM has the same risk as TransCanada (Exhibit B-5, item 49). It also means that Foothills has the same risk as NOVA, at least in respect of the portion of the Foothills cost of service that is rolled-in to the NOVA cost of service and at least for so long as the assignment to NOVA of Pan-Alberta's transportation contracts in Zone 6 continues (5T783-785).

-- Both TQM (5T779) and Foothills (Northern Pipelines Decision, page 4-143) started their lives with requests for approval of a 75/25 debt-equity structure. Both have been able to finance their operations since they came onstream in the early 1980s, TQM with long-term bonds sold in the public markets with a BBB bond rating, while Foothills has chosen not to go to the public markets.

-- Increases in the common equity component of the capital structure of both Foothills and TQM would increase the tolls of the pipelines. Mr. Reid candidly acknowledged that fact in this case (4T620). In the

1386
CAPP Arg.
(Yates)

RH-2-88 Decision of this Board in respect to TQM, one of the reasons cited by the Board for declining to increase TQM's deemed common equity from 25 to 30 per cent was the fact that the Board had not been persuaded that such an increase would be cost-effective from the perspective of the tollpayer (NEB Reasons for Decision Trans Quebec & Maritimes Pipeline Inc., RH-2-88, December 1988, Tolls ("RH-2-88 Decision"), pages 7-9).

-- Shippers on Foothills have access to all 48 states in the United States, through exchanges (4T562), but Foothills suggests that it is riskier because it is solely an export pipeline (3T373; 3T547).

There is an interesting comparison to be made to TQM here. TQM serves the Quebec market, which is acknowledged to be "very risky" (5T778). TQM does not serve the U.S. market. But nevertheless, TQM has been significantly affected by the U.S. market. As explained by Dr. Waters, difficulties of exporting electrical power generated in Quebec operated to stifle expansion and development of the TQM market (7T1166-1167).

1387
CAPP Arg.
(Yates)

In my submission, there are several problems with the assertion by Foothills that it has greater risk because it is solely an export pipeline.

Firstly, I raise the question as to whether Foothills really is only an export pipeline -- and I raise that question in the context of the evidence that is on this record in respect to circumstances in Zone 6 and Zone 9.

Foothills delivers more gas at the end of Zone 6 than is possible to deliver into Zone 9. Foothills responds to APMC/CAPP IR 29.18 (Exhibit B-4, item 29.18) states that NOVA's contract volume on Zone 6 was 2075 million cubic feet a day in 1992. NOVA is the sole shipper on Zone 6.

And in response to APMC/CAPP IR 48.1, Foothills states that Zone 6 capacity is 2075 million cubic feet a day, while the Zone 9 capacity is only 1480 million cubic feet a day (Exhibit B-4, item 48).

What happened to the rest?

The difference -- which amounts to about 29 per cent of NOVA's total contract in Zone 6 -- would not appear to have anywhere to go but into the TCPL system. If that is so, then Foothills

1388
CAPP Arg.
(Yates)

is not an export-only pipeline (See Exhibit B-9, Response to NEB Request No. 89, page 89-3).

When Mr. Pierce says "we would sure love to have some of TransCanada's Canadian market" (4T580-581), these numbers make one wonder whether he is being somewhat disingenuous? On the numbers in the evidence of this record, Foothills would appear to be shipping gas that does go into the TransCanada system.

But even if these numbers are wrong and Foothills is in fact entirely an export pipeline, so what? It has the potential to serve a wide diversity of markets in the United States. It reaches more markets than TransCanada, or ANG, or Westcoast (4T562).

U.S. demand is recovering. It is up to 21 trillion cubic feet estimated for 1995, and that is up from 16 1/2 in 1986, and it is expected to grow more (7T1301; 4T565).

It is the position of CAPP that market risk is reduced with increased diversification of markets. And with the advent of the Free Trade Agreement, there should be less and less difference between Canadian and American markets, until they are eliminated.

1389
CAPP Arg.
(Yates)

In this connection, Foothills did a lot of arm waving about the difficulities that it will now encounter from state public utilities commissions (See, e.g., 3T459).

As I believe you commented, Mr. Illing, that is a risk that has not changed, and it is a risk that affects all pipelines. State regulatory agencies have been required to approve prices of gas sold in their jurisdictions since Foothills started.

The same is true of provincial

regulatory agencies in Canada, such as the Ontario Energy Board and the Regie du gaz in Quebec.

Deregulation has not increased the risk associated with state regulatory approvals; it has simply reduced the number of levels of regulation, which, in the submission of CAPP, reduces overall risk.

This concept of risk is one that should be reflected upon. How much risk is there and, more importantly, who bears it?

The Foothills throughputs have been as low as 25 per cent on the Eastern Leg and as high as 100 per cent on the Western Leg. Market prices have gone through a complete cycle since Foothills

went into operation.

The volatility of these dramatic changes in the market has not impacted on Foothills earnings. It has a cost of service. It has always achieved its allowed return on equity.

So who has borne the risk? The answer is: Not Foothills, but the buyers and sellers of gas.

Whatever the risks of an export market may be, they are not borne by the pipeline. Whatever those risks might have been, CAPP submits that they have diminished through the advent of market-based pricing, the opening up of transportation capacity in the United States, the Free Trade Agreement, and the reduction of transportation costs.

I will not spend much time on the Tariff issue or comparing the Foothills cost of service tariff to that of TransCanada. The Board dealt with that issue in depth in 1979, when it concluded that the Tariff that was then proposed by Foothills would cause shareholder earnings to be more independent of the level of debt capitalization than was the case with TransCanada or other Canadian gas pipelines having a tariff

structure like that of TransCanada (1979 Decision, pages 3-30, 3-31), and that was because the Tariff provides only for the potential abatement of charges related to the return on and of equity.

The charges incorporated in the Tariff relating to a return on and of debt capital would not be subject to any abatement, even in the event of service interruptions.

It appears from the evidence of Mr. Palmer that the relative Tariff situation is the same today as it was then. Foothills has a cost of service Tariff. It has always recovered its costs (3T368ff).

I found it mildly amusing, this morning, to hear Mr. Lutes provide you with a bunch of evidence about TransCanada which was not evidence that had been put on the record by any witness. What was amusing was that after having made these comments to you, he said "there is no evidence on this record that TransCanada has ever had an abatement".

In my submission to you, there is no evidence to support Mr. Lutes' comments in respect to TransCanada, other than Mr. Lutes' own assertions -- which are, as we know, not evidence.

1392
CAPP Arg.
(Yates)

As Mr. Pierce might say: "He should know better than that."

All of these circumstances that I have been relating to you suggest that the most apposite inter-pipeline comparison would be between TQM and Foothills. The business risks of each are similar and warrant a 25 per cent common equity ratio.

It is appropriate, in this context, to consider the relationship between business risk and common equity ratio and rate of return on common equity.

Dr. Sherwin argues, in his characteristically vociferous fashion, that business risk is completely determinative of common equity ratio.

Dr. Waters -- in a lengthy discussion with you, Mr. Priddle -- reiterated the position that he has taken in various cases, that return on equity and common equity ratio are inextricably interlinked, and that they must be considered together (7T974).

We must remember that business risk is sometimes referred to as the "physical, economic, political, competitive and regulatory risk to which the income-earning potential of the business assets

1393
CAPP Arg.
(Yates)

is exposed". The financial risk simply relates to the way in which the assets of a corporation are financed.

This, too, is an issue of relativity in the determination of investment risk. The lower the business risk, the higher the financial risk can be in order to create investment risk that is acceptable to investors.

Dr. Waters' position is that he has essentially equated the risks of Foothills and TransCanada through his recommendations relating to capital structure and return on equity. The 25 per cent common equity ratio and 11 per cent rate of return recommendation for Foothills equates to 10-5/8ths on 28.

This is consistent with the return on common equity Dr. Waters would have recommended today for TransCanada if he were to have utilized a common equity ratio of 28 per cent for TransCanada as being the lower end of his range in his most recent TransCanada appearance (7T1281).

Dr. Waters recommends, and the Board should accept, that in the case of Foothills, the appropriate course of action is to provide 25 to 50 additional basis points in the rate of return,

1394
CAPP Arg.
(Yates)

rather than increase the common equity ratio, because the latter alternative is significantly more expensive to tollpayers.

This issue of cost to tollpayers is very relevant to the "that is them, this is us" comparison. On this subject, Foothills has been dramatically inconsistent.

Mr. Reid says that Foothills suffers in the competitive marketplace from being the most expensive transmission system (3T404; 3T407; 3T410).

Mr. Cameron says that it is critical for Foothills to get its tolls down (3T405).

In recent years, Foothills' tolls have been reduced (4T623) through reduction of the depreciation rate and the adoption of flowthrough income tax. But in this case, Foothills seeks to raise its common equity ratio from 25 to 35 per cent; or effectively, more than 40 per cent.

Mr. Reid says he wishes to do this in order to be put into the same position as other pipelines -- presumably meaning Westcoast, since it has a 35 per cent common equity ratio (3T620ff).

Mrs. McLeod acknowledges, as did Mr. Reid, that the increase in common equity would

increase the tolls. Both fall back on Mr. Reid's response that this increase would result in what he described as a "balance" (4T620).

The fact, Mr. Chairman and Members, is that an increase in the common equity ratio runs directly counter to all the steps that have been taken to reduce Foothills' tolls. The increase in common equity ratio, including the tax effect, may not put the tolls at the same high level as they were before the changes were made to the depreciation rate and the tax accounting method (4T623), but it would nevertheless reduce the competitiveness of Foothills in markets which it is seeking to serve.

When you consider that Foothills has no present need for additional deemed common equity for financing purposes, the requested increase makes absolutely no sense at all.

This, again, is an issue of relativity. Foothills is a relatively expensive transporter of natural gas. Foothills has been becoming relatively more competitive through the reduction of its tolls by lower depreciation rates, changing to flowthrough tax, and increased load factors. To raise the common equity ratio would

make Foothills relatively more expensive and relatively less competitive at a time when relative competitiveness is critical to access to deregulated natural gas markets.

It was in this vein of relativity that I listened with some interest to Mr. Lutes' comments about Northern Border, and to your discussion, Mr. Priddle, with Mr. Lutes after his argument was completed.

In my submission to you, the Northern

Border comparison, upon which Foothills seeks to rely, is a specious one.

The Board has in the past rejected the concept of comparative returns on equity and capital structures. It did so -- as I remember too well -- when it confirmed, I believe in 1988, that it would not consider the regulatory treatment by FERC of the Great Lakes Gas Transmission tolls in considering whether TransCanada's tolls, which included Great Lakes tolls as Transmission by Others, were just and reasonable for TransCanada's tollpayers.

And the Decision in that case shows that the Great Lakes actual return on equity in those years reached almost 40 per cent.

1397
CAPP Arg.
(Yates)

The bottomline on this "that is them, this is us" issue is, in my submission, that Foothills is most comparable to TQM, which has a 25 per cent common equity ratio and which has successfully raised funds in the markets.

Even if the Board believes that Foothills is more comparable to TransCanada, Dr. Waters has provided you with a way to minimize Foothills' tolls, and that is by keeping the common equity ratio at 25 and giving Foothills something extra in its return on equity.

FINANCEABILITY

I will turn now to the issue of financeability.

It is the submission of CAPP that Foothills does not need to raise its common equity ratio to ensure financeability. Even if it could be argued that, on a generic basis, more common equity is justified, that position is definitely not justified now.

Let's turn to the facts again. Foothills requested a 75/25 debt-equity ratio in 1977. It has managed to raise funds on the basis of that capital structure. In 1990, it managed to renegotiate its loans at better spreads than before

1398
CAPP Arg.
(Yates)

under that capital structure.

I remind the Board that Foothills did not want to have this hearing. It strenuously and vociferously objected to having a hearing, and is only here because the Board directed it to file an application.

Foothills was content with 25 per cent -- and it was more than content: it struggled to retain the 12 1/2 or 25 that was put in place by the settlement late last year. Yet, when the Application was filed on May 28, 1993, we suddenly had a request for a 40 per cent increase in capital structure.

Now we must ask: Why? Does Foothills think of these hearings as some sort of labour arbitration where you ask high in hopes of get something less than what you ask for but something more than what you've got?

I asked Mr. Dooley about this, and what he told me was that at the time of the settlement at 12-1/2 on 25, late last year, he did not even contemplate whether an "A" rating was required for financing. When specifically asked why Foothills did not apply for 13 on 35 until after the Board had directed that it file an application,

1399
CAPP Arg.
(Yates)

Mr. Dooley said, and I quote:

> "We determined that this was not the appropriate year in which to make that application, and that we were prepared to wait until a later date to do that, given the number of things that were before us at that time." (1T39)

He acknowledged that negotiations with respect to the banks would probably not start this year, and said that establishment of an "A" rating "well prior to November 1997" -- and I quote his phrase -- "could mean as early as the next year or so" (1T35) or as late as November 1995.

These are exceptionally vague words from which only one conclusion can be drawn, and that conclusion is that Foothills does not need an increase in its common equity now.

Mr. Reid suggested that it was desirable to get an "A" rating now so that Foothills could establish a "track record" before it actually had to refinance its loans (4T633). I asked Mrs. McLeod about that later. She did not appear to agree. She said that a company going to the market for the first time would not have a track record and that what would be necessary was

1400

CAPP Arg.
(Yates)

education of the marketplace (5T770ff). Education does not require an "A", but education can get you an "A".

The topic of financeability, by necessity, involves the issue of interest coverages. Mrs. McLeod cites the guidelines of the Canadian Bond Rating Service and the Dominion Bond Rating Service for an "A" rating, and says that pre-tax interest coverages of 2 times and 40 per cent common equity are required to achieve an "A" rating. She acknowledges, however, that the guidelines are just that -- they are guidelines -- and are subject to deviation in particular cases (4T746-747).

Mr. Lutes has suggested certain criticisms of Dr. Waters under the theme "Do as I say, not as I do".

I have to admit that the theme is a catchy one -- not when applied to Dr. Waters but when applied to the bond rating agencies.

The guidelines say 2 times and 40 per cent common equity. The actuality is significantly less.

We have the Alberta Gas Transmission Division of NOVA at 1.92 in 1992, and NOVA

1401
CAPP Arg.
(Yates)

maintains its "A" rating. We have the AGTD at 1.83 in 1993 which the Public Utilities Board of Alberta says in its decision we will keep it at an A(mid) (Alberta Public Utilities Board Decision E93060, p.71) level.

We have Westcoast recently upgraded to "A" by both CBRS and DBRS, with 1992 interest coverages of 1.55 and actual common equity of less than 21 per cent (4T747ff; Ex. C-1-16).

Then we have Foothills, in 1987, getting a provisional A(low) debt rating from the DBRS when its capital structure was 25 per cent (McLeod Evidence, Ex. B-4, p. 24).

In this context, it should not be forgotten that the common equity of Foothills is not limited to the 25 per cent that is deemed. It also includes the incentive rate of return.

The historical result has been that the

common equity has reached levels significantly higher than 25, as high as 29. It has never gone below 25.

The only point I am making here is that the actual strength of Foothills, the actual financial strength of Foothills, is greater than would result from a deemed common equity ratio of

1402
CAPP Arg.
(Yates)

25 per cent alone.

We do not know if Foothills could get an "A" rating at 12 on 25. Mr. Dooley did not care to contemplate that last December (1T39).

We do not know whether Foothills could get an "A" rating at 11 on 25. We do not know whether Foothills needs an "A" rating in order to finance its pipeline. TQM did not (5T777-780).

We do know that Foothills has not gone to the public market to see whether it could get an "A" rating or could sell bonds with less than an "A" rating, as TQM has done.

In this context, I was interested to hear Mr. Lutes pose a question to Dr. Waters on the last day of the evidence, in which he suggested or implied that Foothills had sought access to the public debt markets as late as the summer of 1992 and had failed (7T1213).

I could not find any evidence on the record that Foothills had sought to go to the public markets in 1992.

Mr. Reid was asked when Foothills had last had advice from its financial advisors that it could not raise funds in the public markets. He undertook to advise the Board in that regard, and

1403
CAPP Arg.
(Yates)

the subsequent response (5T769ff) simply confirmed that Foothills had attempted, on more than one occasion, to access public debt markets but in each instance was advised that "they could not be sold" (Ex. B-14, p. 5, No. 14).

Mrs. McLeod, Foothills financial advisor, indicated that she could not remember when Foothills last considered going to the public markets. She said that there had been some work done on gearing up for a Foothills offering immediately before she arrived at ScotiaMcLeod, which was in the winter of 1990, but none since (5T 774-775).

So the Foothills financial advisors have not done any work on a public transaction in the last 2 1/2 years.

I raise this, Mr. Chairman and Members, simply as further evidence that, in Foothills' view, it does not need access to public markets now. CAPP agrees.

INCOME TAXES

The subject of income taxes received a lot of air time in this proceeding.

The drawdown of deferred taxes was a specific issue, and the 1992 tax shelter investment

1404
CAPP Arg.
(Yates)

of Foothills was discussed at length.

Foothills resisted providing information about deferred taxes until it was directed to do so by the Board (See Ex. A-10).

It became clear, during cross-examination, that a drawdown of the deferred tax balance, which eliminated taxes from the revenue requirement of Foothills would reduce the desirability to Foothills of the investment in the Joint Exploration Company that Foothills made in order to shelter its shareholders from tax liability.

In 1992, Foothills collected $8.2 million from its shippers for income taxes payable under the flowthrough method of income tax determination (Ex. B-1, Volume 1 Application, Tab 1, page 1-2). It appears that only a small portion, if any, of those taxes were actually paid by Foothills to the Government, in respect of 1992.

Through the tax shelter, this money found its way to the shareholders of Foothills, which effectively increases their return on equity.

In 1993, Foothills is forecasting income taxes for inclusion in the cost of service

1405
CAPP Arg.
(Yates)

of $8.6 million (Ex. B-1, Volume 1 Application, Tab 1, page 1-32). It is also the evidence in this proceeding that more than $100 million of renounced resource tax expense remains available to reduce taxable income in 1993 and thereafter (Ex. B-9, Item 56, Note 9).

CAPP is concerned that this Foothills investment is a start down the slippery slope to the quagmire of the utility/non-utility debates that have characterized the hearings of other pipelines before this Board.

The Association is also concerned about the concept that taxes can be collected from tollpayers but sheltered by the shareholders of the pipeline.

In this era of increased pipeline competition and concern about transportation costs, it would, in the view of the Association, be better if regulated utilities were required to take all reasonable and prudent steps to minimize the tax expense to the tollpayers, rather than to the pipeline shareholders.

Notwithstanding all this, CAPP does not recommend that the drawdown of deferred taxes on Foothills commence in 1993. As indicated in the

CAPP Evidence, the Association is concerned about the minimization of financing impacts of any drawdown and of the response of Foothills' lenders to a drawdown financing proposal. CAPP, therefore, reiterates the request contained in its Evidence that the Board direct that Foothills analyze the financing impacts of a deferred tax drawdown, prepare a drawdown financing proposal, and present that proposal to the Board and its lenders (CAPP Evidence, Ex. C-1-5, p. 5).

CAN-AM EXPENSES

It is difficult to deal with operating and maintenance costs. Perhaps the Board should look at this, too, as a relativity issue, and encourage comparisons between pipelines.

The Board should certainly require full and detailed disclosure of costs that are incurred. There is one matter of "costs" that CAPP wishes to speak to, and it is the $765,000 of CAN-AM expenses.

It appeared from the cross-examination conducted by counsel for the APMC that Foothills has been recovering a return on the CAN-AM expenses since 1985 (Ex. C-24-8). In these circumstances, it is more than a little puzzling that Mr. Cameron

1407
CAPP Arg.
(Yates)

would, in his evidence, seek to have these costs included in rate base (Prepared Evidence of T.L. Cameron, ("Cameron Evidence"), Ex. B-4, p. 2-11 - 2-12).

In order to recover the CAN-AM costs or any return on them, Foothills should be required to discharge an onus of showing that the expenditures were in respect to matters that are used and useful in providing service.

The vague responses provided by the Foothills' witnesses in cross-examination are, in the submission of CAPP, not completely satisfactory in this regard (1T44ff; 2T460ff).

Having considered the evidence, CAPP takes the position that certain of the applied-for costs should not be included in rate base as they have not added in any way to the value of the current facilities configuration. Expenses relating to the comparison of competing projects are examples.

Costs such as those related to engineering design could, however, be considered as adding value and therefore be justified.

CAPP would, on this topic, only leave the Board with the request that the Board examine

1408
CAPP Arg.
(Yates)

this evidence carefully before deciding what costs, if any, can be included.

Perspective on Costs of Capital:

I would like to speak now for a few moments about cost of capital and look at the perspective on the costs of capital.

This proceeding is being held at a time when interest rates and costs of capital generally have fallen to levels not experienced since the 1970s.

Short-term rates, as represented by the Canadian chartered banks' lending rate to prime quality borrowers, are currently at 5-3/4 per cent; one bank is at 6. That is a 28-year low. Long-term rates, as measured by the Bank of Canada "10-years and over Government of Canada series" are at 7.4 per cent as of August 25th.

It is necessary to go all the way back to 1973 to find a lower rate.

The yield prevailing on August 27th for U.S. 30-year treasury bonds was 6.13 per cent, the the lowest level since auctions of such bonds were initiated in 1977.

Interim tolls were established for Foothills in 1992. The NEB held a hearing for TQM

1409
CAPP Arg.
(Yates)

in December of 1992. It is noteworthy that subsequent to that time, interest rates have fallen substantially across the board. The details are provided in Dr. Waters' update to the Table which appears at page 5 of his Evidence (Exh.C-1-6). I will not look at that in detail, but I would like to highlight three of the entries.

First, the chartered banks' prime rate was at 7.75 per cent. It is now at 5.75 per cent, down 200 basis points.

Second, the Bank of Canada "10-years and over Government of Canada series" yield has declined by 127 basis points, to the current level of 7.4 per cent that I mentioned a few moments ago.

And third, the yield on U.S. Government 30-year treasury bonds has fallen from 7.42 to 6.13, a decline of 119 basis points.

Nor are these observed declines likely to have taken costs of capital for Canadian corporations to their ultimate lows. Dr. Waters' analysis of current and prospective economic conditions, both globally and for Canada, indicates that economic prospects are anything but bright. And even if deficit cutting by government becomes

1410
CAPP Arg.
(Yates)

the rule, the result will, at least in Dr. Waters' view, be a further reduction in interest rates and cost of equity capital.

That was in a discussion which he had with you, Mr. Priddle (7T1245-47).

Now, this is the economic and financial markets backdrop against which evaluations should occur of the recommendations of Dr. Waters on behalf of CAPP and the APMC and of the recommendations of Mrs. McLeod and Dr. Sherwin and

Ms. McShane for Foothills.

Let's look for a moment at those recommendations.

Dr. Waters recommended that Foothills be awarded a rate of return on equity within the range of 10-1/2 to 11-1/2 per cent, on a deemed equity rate of 25 per cent.

That recommendation became 10-1/2 to 11 in light of Dr. Waters' opening comments indicating a range of 7-3/4 to 8 for Long Canadas for 1993 instead of the 7-3/4 to 8-1/4 which he had used in his original Evidence.

Dr. Waters' recommended range was based on his application of the Equity Risk Premium methodology, and it incorporated three parameters:

The first was the range for the Government of Canada long-term bond yield; second, was an equity risk premium of 2-1/2 to 2-3/4 per cent for Foothills, that risk premium being the sum of a premium of 2-1/4 per cent for lowest-risk utilities plus 25 to 50 basis points to compensate for any incremental investment risks that might be perceived by investors as applicable to Foothills; and third, a cushion of 25 to 50 basis points to ensure that under all but the most extreme circumstances, Foothills' rate of return will exceed the investors' required rate of return throughout the Test Year.

As I indicated a moment ago, with respect to the first item, Dr. Waters indicated, in his updating statement, that a range of 7-3/4 to 8 is realistic for all of 1993, given the level of yields to date and their current level.

The second item (which is to say the risk premium) is based on Dr. Waters' estimate of 4-1/2 per cent maximum for the equity market risk premium and a relative risk factor of .5 for the lowest risk utilities.

An alternative view of the 25 to 50 basis point additional premium for Foothills is

that it is equivalent to awarding Dr. Waters' recommended rate, absent this increment, to a common equity ratio of 28 per cent rather than 25.

The recommendations of Foothills' witnesses are quite different. Foothills' witnesses initially recommended a rate of return on equity in the order of 13 per cent. Mrs. McLeod and Dr. Sherwin and Ms. McShane lowered that recommendation, lowered both of their recommendations, in their updating and rebuttal submissions. Dr. Sherwin and Ms. McShane came to 12.625 (Page 6 of the Additional and Rebuttal Evidence of Sherwin/McShane Exh. B-10), and Mrs. McLeod came to the upper end of the range of 12 to 12-1/2 (Page 3 of Mrs. McLeod's Updating Evidence, Exh. B-10).

In greatest contrast to Dr. Waters' recommendation, all the Foothills' witnesses recommended that the deemed common equity ratio be increased from 25 to 35 per cent, a jump of 40 per cent.

The submission of CAPP is that, taken together, the rate of return and deemed common equity recommendations of Foothills' witnesses are remarkably discordant with financial market

conditions, as exemplified by long-term interest rates. They are also incompatible with the risks of Foothills, in both absolute terms and relative to other utilities regulated by this Board.

The unreality of the McLeod/Sherwin/McShane equity rate of return recommendations is even more apparent when they are assessed against long-term interest rate levels.

Were the Board to grant the requested 12-1/2 per cent, Foothills would, given its cost of service tariff, achieve a risk premium in the range of 4-1/2 to 4-3/4 per cent.

This is the result of subtracting Dr. Waters' estimate of the average yield likely to prevail on Long Canadas over 1993, 7-3/4 to 8, from the requested rate.

That premium would be in excess of 5 per cent if it were calculated in relation to current interest levels.

The prospective equity risk premium is even more excessive when it is recognized that Foothills' equity investors do not bear purchasing power risk. Dr. Waters did not incorporate the purchasing power risk premium in his estimation of the equity market risk premium, but he did

1414
CAPP Arg.
(Yates)

recognize that in assessing the extent to which his recommended rate of return of 10-1/2 to 11-1/2 for Foothills provided compensation to its shareholders for the risks to which they were exposed.

On page 2 of his Evidence, Dr. Waters concluded, and I quote:

"... long-term Government of Canada Bonds incorporate a premium for the risk of purchasing power loss, a risk not borne by Foothills' common equity investors. Accordingly, the premium inherent in my recommendation for the risks which are in fact borne by the common shareholders exceeds the 2 1/2-3 1/2 percentage points range by the amount of the purchasing power risk premium component of long-term bonds yields. I have estimated this premium to be in the order of 75 to 125 basis points."

Viewed in this way, the equity risk premium inherent in the applied for rate is in the order of 5-1/2 percentage points (Dr. Waters' Evidence, Exh. C-1-6, page 4).

Mr. Chairman, I have a few comments

1415
CAPP Arg.
(Yates)

left to make in respect to the rate of return methodologies. I am prepared to do that now, or after the break. I am in your hands....

THE CHAIRMAN: Thank you, Mr. Yates. I think we will take our break now, and recommence at ten minutes past eleven.

--- (Short recess)

1416
CAPP Arg.
(Yates)

--- Upon Resuming

THE CHAIRMAN: Mr. Yates, please.

Rate of Return Methodologies:

MR. YATES: Mr. Chairman and Members, I want now to make a few comments on the rate of return methodologies.

In arriving at his rate of return recommendation, Dr. Waters relied exclusively on the results of his application of the Equity Risk Premium Test.

He makes no apologies for that exclusive reliance.

Foothills' witnesses relied, to different degrees, on the Comparable Earnings, Discounted Cashflow and Equity Risk Premium methodologies -- and it is the relevance of those methodologies that I want to comment on now.

The Comparable Earnings Methodology:

Dr. Sherwin and Ms. McShane acknowledge in their testimony in this case that the Comparable Earnings methodology is not useful today.

At page 4 of their Additional and Reply Evidence, they conclude that their attempt at projecting profits for a nine-year cycle beginning in 1992 has not produced results "... sufficiently

1417
CAPP Arg.
(Yates)

reliable to provide a basis for utility return awards" (Additional and Reply Evidence, p.4).

CAPP submits that this conclusion by Dr. Sherwin and Ms. McShane puts an end to the matter of the test's applicability in this case.

While their giving a 30 per cent weight to a value of 12-1/4 to 12-1/2 per cent for their Comparable Earnings Test reduces their overall recommendation slightly, it is, in the submission of CAPP, simply an excuse for not abandoning the methodology entirely. In effect, what Dr. Sherwin and Ms. McShane have done is to take a "raincheck" on the Comparable Earnings Test.

Mrs. McLeod also gave some weight --

apparently relatively little -- to the Comparable Earnings Test; and in CAPP's submissions, her results should also be ignored, for the reasons given by her fellow rate of return witnesses.

The Discounted Cash Flow Methodology:

Turning to the Discounted Cashflow Methodology, we know that Dr. Waters gave no weight to his DCF results. We know that Dr. Sherwin and Ms. McShane gave 10 per cent weight to their results, and that Mrs. McLeod gave something less than the "primary" weight that she gave to the risk

premium analysis.

The essence of applying the DCF test is developing an estimate of the rate of growth in dividends anticipated prospectively by investors. That rate is, in turn, clearly dependent on the future levels of earnings for the sample companies.

Dr. Sherwin and Ms. McShane told us that they could not project profits which, to quote them again, would be "... sufficiently reliable to provide a basis for utility return awards" (Additional Reply Evidence, page 4).

It is the submission of CAPP that without an ability to project the fundamental earnings data, there exists no basis for assessing the dividend growth rates anticipated by investors. Accordingly, the results of that test should be ignored, and Dr. Waters is shown to be the most reasonable of the witnesses by restricting his analysis to the Equity Risk Premium methodology.

Equity Risk Premium Methodology:

That methodology was, of course, relied on by all of the witnesses: Dr. Waters exclusively; Dr. Sherwin and Ms. McShane gave it 60

per cent weight; and Mrs. McLeod gave it "primary" weight.

That methodology involves the determination of three elements (and we talked of these before) the first being the base long-term Government of Canada bond yields -- and Dr. Waters concluded that to be in the range of 7-3/4 to 8 in 1993; and in his formal application of the test, Dr. Waters had used the wider range of 7-3/4 to 8-1/4. Dr. Sherwin and Ms. McShane used a value of 8, while Mrs. McLeod used a value of 8.2.

CAPP submits that in the light of the continuing downward trend in long-term rates, the maximum value to be considered appropriate is 8.0 per cent, which is the upper end of the 7-3/4 to 8 per cent range developed by Dr. Waters.

The current value of the equity market risk premium to be used in the application of the methodology is, of course, a contentious matter. Dr. Waters' estimated the value to be 4-1/2 per cent maximum; Mrs. McLeod weighed in with a range of 5 to 7; and Dr. Sherwin and Ms. McShane occupied the middle ground, at 4-1/2 to 5 per cent.

Dr. Waters' value of a maximum 4-1/2 for the equity market risk premium is based on his

1420
CAPP Arg.
(Yates)

analysis of the geometric mean values of the achieved equity risk premiums in Canadian markets over the period 1926 to 1992 and the sub-period 1950 to 1992.

Dr. Waters' basis for utilizing geometric mean values rather than arithmetic means is an issue that has arisen in various previous proceedings, and his reasoning is set forth in Appendix XIII of his Evidence.

CAPP urges the Board to give particular attention to the analysis that is contained in that Appendix.

Dr. Waters acknowledges that the historical mean values are sensitive to the happenstance of outcomes from year to year in financial markets. It is for that reason that he gave consideration to, among other things, achieved rates of return in the U.S. markets and the analysis undertaken by Dr. Jeremy Siegel, which is cited in his Evidence.

The risks of Foothills' equity relative to that of the equity market as a whole is the third element that must be evaluated in applying the Equity Risk Premium methodology.

Dr. Waters undertook a two-stage

1421
CAPP Arg.
(Yates)

approach to this. First, he established the relative risk of a group of 10 lowest-risk utilities. The result was a utility risk premium of 2.25 per cent. Second, he added an increment of

25 to 50 basis points for the incremental investment risks of Foothills, should any in fact be perceived by investors. The end result is an Equity Risk Premium for Foothills of 2-1/2 to 2-3/4.

At this point, it is appropriate to compare Dr. Waters' premium for Foothills, this 2-1/2 to 2-3/4, to the premiums which materialize from Dr. Sherwin's and Ms. McShane's "DCF-risk premium" analyses.

Two variants were employed by them. Those analyses resulted in premiums over the last six years averaging 2.2 to 2.8 per cent.

It is the position of CAPP that careful assessment of the input data underlying those analyses, together with those witnesses' weighting methodologies, will result in a conclusion that, if anything, the 2.8 per cent average overstates the premium achieved over the past six years and prospectively anticipated.

CAPP urges the Board to adopt

1422
CAPP Arg.
(Yates)

Dr. Waters' perspective on the values of the components of the Equity Risk Premium Test. That perspective resulted in Dr. Waters concluding that the fair rate of return for Foothills was 10-1/2 to 11-1/2, inclusive of a cushion of 25 to 50 basis points.

The latter, of course, is incorporated primarily to insulate Foothills' investors from uncertainty as to the cost of capital levels over the test period.

With Dr. Waters' conclusion that the average yield on long-term Government of Canada bonds over 1993 will be no more than 8, it will be appropriate, in CAPP's submission, to award Foothills a rate of return on common equity in the range of 10-1/2 to 11.

Incentive Rate of Return:

Mr. Lutes addressed you earlier today on the topic of the incentive rate of return. Foothills does not propose to apply the incentive rate of return scheme to expansion facilities added to its Prebuild segments since the original line was placed in service. (Cameron Evidence, Ex. B-4, p. 2-11).

CAPP, in its evidence, has agreed with

1423

CAPP Arg.
(Yates)

Foothills that the IROR scheme is not appropriate for additions to the existing Prebuild pipeline system (Written Evidence of CAPP, July 1993, p. 5, line 24 to p. 6, line 5).

At the commencement of the hearing, the Board asked Foothills, and any other party that wished to do so, to address in final argument the legal basis upon which the Board could grant Foothills' request (1T5).

Mr. Lutes has already provided the Foothills' position in respect to this issue. CAPP has no reason to disagree with the arguments put forward by Mr. Lutes and has nothing to add to those arguments.

CONCLUSION

In conclusion, Mr. Chairman and Members, I remind the Board that the onus of proof in this proceeding lies on Foothills as the Applicant. Foothills has asked for a 40 per cent increase in its common equity ratio, and Foothills has asked to maintain its rate of return at 12 1/2 per cent. Foothills has the burden of convincing you that both of those numbers are justified.

In the submission of CAPP, that burden has not been discharged. Foothills only applied

1424
CAPP Arg.
(Yates)

for a 35 per cent common equity ratio when it was dragged into this hearing. The Foothills evidence, in the submission of CAPP, relating to common equity ratio, is far from persuasive.

There is absolutely no cogent evidence that increased common equity is required at this time. By contrast, the contrary evidence is compelling. Foothills has done just fine at 25 per cent, and it needs to keep its tolls down to remain competitive in the world of deregulated natural gas markets and prices.

CAPP submits that the Board should leave Foothills' common equity ratio at 25 and should set the return on equity at a level no higher than 11 per cent.

Those are my submissions, Mr. Chairman, unless there are any questions.

MR. PRIDDLE: Mr. Yates, in your submission, the Board should look only at the Equity Risk Premium approach to determining what is a fair return on equity.

Is that correct?

MR. YATES: Yes.

MR. PRIDDLE: Mr. Yates, I have a technical question. You recall that Mr. Lutes

1425
CAPP Arg.
(Yates)

cited part of the Justice Lamont dictum about fairness in regulatory awards, from a Supreme Court of Canada case.

I want to ask you whether, in your view, a return on equity award which is based only on the Equity Risk Premium approach satisfies the Lamont criteria, especially the criterion that had to do with investment opportunities in comparable risk businesses, which I tend to read as meaning private-sector investment opportunities?

MR. YATES: Mr. Priddle, I will respond this way: I do not have the wording of the Lamont decision in front of me at the moment, but my recollection of that decision is that it does talk in terms of the "fairness" standard but does not talk in terms of any particular tests or any particular manner in which the fairness standard could be applied.

In the particular situation of this case, we have the Comparable Earnings Test -- unique, in at least my limited experience -- being denigrated by its own previous proponents. We have a Comparable Earnings Test that Dr. Sherwin and Ms. McShane have essentially said is not reliable in determining the rate of return.

1426
CAPP Arg.
(Yates)

That says to me that the Comparable Earnings Test, in their view, is not one from which they can reach conclusions in this case as to the compliance with the "fairness" standard.

I would respond by saying that while the Lamont test does establish the need for fairness, when you have a test here which, in the practice of this Board, has been utilized, or has been heard in evidence, to be a "fairness" standard, a test which is now unreliable, any kind of reliance on what is an unreliable test would in itself violate the standard that was set forth by Mr. Justice Lamont.

MR. PRIDDLE: Thank you, Mr. Yates.

THE CHAIRMAN: Thank you, Mr. Yates.

MR. YATES: Thank you, Mr. Chairman and Members.

THE CHAIRMAN: Mr. Hart, I believe you wish to present argument.

ARGUMENT ON BEHALF OF NATURAL GAS PIPELINE COMPANY OF AMERICA:

MR. HART: Mr. Chairman, Members of the Board, first let me thank you for accommodating me in appearing for argument this morning, not having registered our appearance at the outset of these proceedings.

I had also hoped to thank Mr. Syme for his assistance in that regard, but it looks as though I am too late to thank him personally. I will have to thank him through the record and, perhaps, you personally, Mr. Noonan, as a representative of the Law Branch.

Mr. Chairman and Members of the Board, as our intervention in this proceeding (Exhibit C-9-1) indicates: Natural Gas Pipeline Company of America is a United States corporation which operates an interstate natural gas pipeline system under the jurisdiction of the U.S. Federal Energy Regulatory Commission.

Natural has been a significant purchaser of Canadian natural gas for over 20 years. On the Foothills system specifically, Natural has been purchasing Alberta gas since approximately 1982, under its ProGas contract, for

75 million cubic feet a day.

The price paid by Natural for these volumes includes a demand component, which is comprised of transportation costs in Canada, a significant portion of which are costs of transportation on the Foothills system.

It is clear, therefore, in our respectful submission, that Natural has a vital interest in these proceedings, which will establish tolls on the Foothills line.

We wish to address, briefly, only one issue, and that is the issue of drawdown of the Foothills' deferred income tax balance.

We have reviewed the Written Evidence filed by both Foothills and CAPP on this issue, as well as the cross-examination arising from that evidence. We have also reviewed the Board's recent Decisions RH-1-92, RH-2-92, and RH-3-92 concerning drawdown of deferred tax balances on the Westcoast and TransCanada systems.

We submit, with respect, Mr. Chairman and Members, that an appropriately-timed and well-conceived plan of drawdown on the Foothills system is important, both to Foothills itself and to those who bear the burden of its tolls.

1429
NGPCA Arg.
(Hart)

The evidence before you indicates that the deferred tax balance has grown to some $135 million, or almost 20 per cent of total rate base.

In light of the fact that Foothills is now on flow-through tax accounting and that cross-over will soon be reached on the assets which are associated with this large deferred tax balance, Natural respectfully submits that the suggestion made by CAPP, at page 5 of its Written Evidence in these proceedings, is a good one and should be adopted by the Board in its Decision.

That suggestion, Mr. Chairman and Members, reads as follows -- and I am looking at the CAPP Written Evidence in these proceedings, page 5, starting at line 15.

"CAPP recommends that drawdown not commence in 1993. CAPP further recommends that Foothills be directed to consider the most appropriate parameters for drawdown; consider whether drawdown would create material financing impacts, and, if so, how those impacts could best be mitigated; and provide the Board and Interested Parties with the results of this review

1430
NGPCA Arg.
(Hart)

by 31 December 1993."

As I say, Mr. Chairman and Members, we would urge the Board to make a direction in its Decision to that effect, allowing the Board, Foothills, and those whose toll payments have created the tax balance, to give proper consideration to an appropriate allocation of these funds to the Foothills cost of service as soon as cross-over has been reached.

In conclusion, Mr. Chairman, I heard Mr. Lutes' suggestions on this issue earlier this morning. I submit that he is moving in the right direction but -- no doubt as a consequence of his advancing years -- a little bit too slowly. He seems to want to delay any action on the matter until the Board's Decision in these proceedings has been issued.

With respect, we do not see the need for this delay. This is an important issue to both Foothills and its tollpayers.

While your decision will clearly bear on the revenue environment, if I may, in which drawdown will occur, we submit, with respect, that a start should be made now and a report filed with the Board by year end.

1431
NBPC Arg.
(Keough)

That completes my remarks, Mr. Chairman and Members, subject to any questions that you may have.

THE CHAIRMAN: Thank you, Mr. Hart. We have no questions.

MR. HART: Thank you.

THE CHAIRMAN: Mr. Keough, do you wish to present argument.

ARGUMENT ON BEHALF OF NORTHERN BORDER PIPELINE COMPANY:

MR. KEOUGH: Thank you, Mr. Chairman. I hope to be briefer than Mr. Hart.

This Argument is presented on behalf of Northern Border, and solely because Northern Border noted, with some concern, the isolated facts related to you by Foothills in its Final Argument regarding the Northern Border capital structure, its rate of return, and the tax methodology under which it is governed.

Mr. Priddle, as with your comments, Northern Border is likewise troubled that this Board should somehow be influenced in its determinations to be made here by these isolated facts, supported by little or no evidence on the record of these proceedings.

1432
NBPC Arg.
(Keough)

The evidence that you have heard does disclose that Northern Border arrived at a settlement of its rate case and that these specific items that I have already mentioned are but a few of a multitude of issues that were considered, negotiated, and dealt with during that settlement.

Without any evidence of the overall settlement, the give and take that various parties would have gone through in arriving at a conclusion on these issues, Northern Border views it as unfair to take isolated conclusions out of context.

You do not have a full record here -- and you appropriately should not -- of the items that went into that Northern Border settlement, and therefore Northern Border would be very concerned if this Board took into account and relied upon the isolated elements that you have heard about regarding its settlement.

In Northern Border's view, it would be inappropriate for you to do that and to use the Northern Border settlement as a precedent for anything that you are going to be dealing with here.

Those are my comments, Mr. Chairman, thank you, subject to any questions.

1433
APMC Arg.
(Moreland)

THE CHAIRMAN: Thank you, Mr. Keough.

MR. KEOUGH: Thank you.

THE CHAIRMAN: Ms. Moreland, you are next.

ARGUMENT ON BEHALF OF THE ALBERTA PETROLEUM MARKETING COMMISSION:

MS. MORELAND: Thank you, Mr. Chairman and Members.

Deemed Common Equity Component:

Mr. Chairman, in the submission of the APMC, this case is in large part about risk. This fact was made abundantly clear to me when, in doing a computer search of the seven days of transcripts of evidence, I found that the word "risk" appeared a mere 938 times!

On the issue of risk, I would like to take the Board, firstly, to Mr. Reid's comments while concluding the Foothills' Opening Statement. He stated there, and I quote:

> "In short, Foothills continues to be exposed to higher business risk associated with ongoing changes in the marketplace, in the gas industry, and in federal and state approaches to regulation." (Emphasis added) (2T235)

It is important, Mr. Chairman, to distinguish the concept of risk from that of change.

According to the Oxford Dictionary, risk is: "a hazard, a chance of bad consequences or loss, or the exposure to mischance".

The critical issue in this case is whether the Board views the "changes" that have taken place in Foothills' environment as adding to, reducing, or leaving unchanged Foothills' exposure to the chance of bad consequences.

The Board is being asked by Foothills to find that its risks have increased and to reflect that increased risk by increasing its deemed common equity component.

As Mr. Priddle and Dr. Waters agreed on the final day of the proceeding, the largest single issue in this case is Foothills' request that its deemed common equity be increased from 25 per cent to 35 per cent (7T1271).

That request is being driven, in large part, by Foothills' assessment of its increased business risks.

The evidence that you have heard over

the course of this hearing has provided a factual

account of the changes which have taken place in Foothills' environment over the past number of years, particularly since the last full toll review in 1984.

In my submission, there is little in dispute about the facts. What is in dispute is what conclusions about risk can or ought to be drawn from the facts.

Foothills takes the position that its risks are greater now than in previous years, largely as a result of the changes in the natural gas markets as deregulation has evolved.

A changed environment does not, by definition, mean an environment fraught with more risk.

In the view of the APMC, the changes referred to by Foothills have not increased the risks of the pipeline. Foothills' risks have decreased since 1984, and an award of 10.5 to 11 per cent return on a 25 per cent deemed common equity component would be commensurate with that risk.

I would like to turn now to a discussion of the various elements of risk which have been discussed in the course of this hearing,

to provide the Board with the APMC's perspective on the conclusions the Board should draw.

(i) Market and Regulatory Risk

Firstly, in respect to market and regulatory risk: Foothills has repeatedly asserted that its risks have increased in its markets in the light of market and regulatory developments. It says it is, in relative terms, a high-cost transporter into the markets served by its shippers, thereby exposing it to increased risk (2T343, 3T405ff).

It says that the new customers on the East Leg are less creditworthy than the original interstate purchasers, and that they are subject to state regulation, both of which translate into increased risk (2T288 and 6T1110).

It says that the West Leg PITCO arrangements are a source of risk, in the light of state PUC action (2T234). It says that much of the gas delivered into the Midwest market is delivered on the basis of short-term gas sales arrangements, thereby increasing the risk, as compared to the time when the underlying gas sales arrangements were long-term firm in nature (4T583).

Mr. Reid stated that the nature of the

1437
APMC Arg.
(Moreland)

tolls -- by which he was referring to the magnitude of those tolls -- and the nature of the markets places Foothills and its shippers at greater risk (3T425).

The APMC makes the following observations about the market risks identified by Foothills.

First, Foothills has achieved extremely high load factors on its system and its shippers are competing effectively in the markets served by that system (3T424). This is in part because Alberta producers have been prepared to accept netbacks which have enabled them to compete in those markets (3T403ff).

The improved ability to compete in the market is also being facilitated by the fact that Foothills' costs are lower now than they were in teh past. The costs are lower as a result of lower depreciation rates (3T426), a lower tax rate (Ex. B-14), the adoption of flow-through tax methodology, a more highly depreciated system (3T426), and lower cost of capital (Ex. B-14). Unit costs on both the Eastern and Western Legs have reduced as a result of expansions (3T434).

In light of the extension of the

1438
APMC Arg.
(Moreland)

"basket clause" trigger date a number of times in the past, it is clear that the outstanding costs which would have to be recovered in the event that the basket clause were to be invoked are lower now than in earlier years of the project (3T420).

In any event, Foothills states that it does not anticipate that it will have to retire its debt pursuant to the terms of the basket provision, which triggers in 1997 and 1999 on the Eastern and Western Legs respectively (4T618).

On the issue of the ability to compete, Mr. Nettleton pointed out that Foothills' shippers on the East Leg may well have the ability to be increasingly competitive on a transportation basis as a result of the ability to access discounted interruptible capacity available in the United States (6T1094).

Foothills' access to the export markets has been enhanced by the Eastern Leg expansion, and the resulting reduction in unit costs on Foothills has helped to make it possible for Alberta gas to compete more easily in that market (2T334).

Foothills has broader access to United States markets than do any of ANG, Westcoast, and TransCanada PipeLines (4T562), and this in an

1439
APMC Arg.
(Moreland)

environment which sees U.S. demand growing from 16.5 Tcf in 1986 to 21 Tcf in 1995, and 22-1/2 Tcf by the year 2000 (7T1301 and 4T565).

Mr. Chairman, it is somewhat ironic that Foothills has acknowledged the need to reduce its costs in order to position itself and its shippers more favourably to compete, yet it has applied for an increased deemed common equity component and return on equity which would result in a toll increase (4T619).

Foothills' transportation contracts with its shippers are long-term, and they are longer term today than they were in the past (2T322). The Western Leg expansion is contracted by ANG for 15 years (2T322). Both Foothills (Saskatchewan) and the West Leg have queues for service (4T613).

Accordingly, in the view of the APMC, the business risks which Foothills has identified are risks to Foothills' shippers, who are obligated to the long-term transportation arrangements, and ultimately to the contracted producers.

Foothills' Tariff is a cost of service tariff, which provides it with a very high level of assurance that it will recover its costs. You have

1440
APMC Arg.
(Moreland)

heard evidence that it has incurred no costs related to billing abatements in the past three years (4T608), and you have heard, significantly, that it has never failed to achieve its allowed return (7T1215).

Moreover, approximately 50 per cent of

Foothills' cost of service is attributable to Zone 6 (Ex. A-12), and those costs are the responsibility of NOVA, which is currently the sole shipper on that portion of the system.

Downstream markets on the Eastern Leg reflect an increase in the number of participants as compared to the few large interstates of the past (see for example 3T422). The presence of a diverse number of shippers is something which Foothills has agreed "generally" lessens the risk of both supply and market failure (2T330). Foothills has also agreed that its shipper constituency on the West Leg is a financially strong one (4T653).

In relation to the regulatory risk identified by Foothills, it has raised the issue of state PUC regulation in respect to the East Leg end-use customers served by the system as a source of increased risk. It has also specifically raised

the issue of the CPUC handling of the PITCO/SoCal contract as a source of risk on the Western Leg. Further, it has gone to great lengths to convey the point that the consistent U.S. Governmental support for the ANGTS and concomitant FERC treatment of the the Prebuild have not shielded Foothills from the vagaries of the market and that increased risk (eg. 2T232 and 3T454).

Mr. Nettleton's evidence in this regard provides another perspective on regulatory risk. In relation to the PITCO matter, the contract was renewed in 1988, in part on the basis of full CPUC support for the arrangement, and the purchase was extended to the year 2012 (2T313 and 7T1081).

Mr. Nettleton expressed his views that there are reasons to be optimistic about the resolution of the PITCO matter (7T1262), and there are numerous options to sustain the PITCO volumes with the opening up of the PG&E/PGT expansion on 1 November 1993, which will provide access to all of California as well as the Pacific Northwest (4T682).

The record demonstrates that FERC has an established track record (2T289) of consistently honouring the special arrangements related to the

(Moreland)

Prebuild facilities. The FERC and U.S. Governmental commitment to the Prebuild has allowed Foothills to be insulated from the application of various otherwise generally applicable FERC policies, which Mr. Reid has agreed helped to ensure that the effects of changes to the broad framework of structural regulation were not as "brutal" as they might have otherwise been (3T454).

The FERC commitment has been affirmed as recently as Order 636-A and in February of this year, when FERC ALJ birchman noted, and I quote:

> "... nothing suggests an impairment of the ANGTS debt guarantees or minimum revenue stream from continued incremental cost allocation of the Prebuild facilities." (2T309).

The current status related to market and regulatory risk on the Foothills system was summed up by Mr. Reid when he agreed, and I quote:

> "... today the PITCO volumes are being sold; the East Leg is full and our shippers are competing successfully in that marketplace. Equally, we are hopeful and -- to use Mr. Cameron's

> word -- optimistic that we will continue to be competitive in those markets." (3T425)

The APMC regards the changes which have taken place in the market and on the Foothills system as positive reactions to the process of open access and deregulation and developments which have not increased Foothills' risk.

As Mr. MacMurchy indicated, the regulated environment was one which created distortions which led, over time, to a non-viable system. In the view of the APMC, today's market-driven system is, in the longer run, one which provides a more stable and predictable business environment, as opposed to the time pre-deregulation (6T1121-1122).

The APMC agrees with Mr. Pierce's characterization of the system as one which, although at one time nearly "terminally ill", has become healthier, in large part as a result of work, effort and change (3T410).

The APMC therefore submits that the Board can find, on the facts before it, that

Foothills' business risks have not increased and do not warrant an increase in the deemed common equity

1444
APMC Arg.
(Moreland)

component.

(ii) Financing Flexibility

I would like to move, for a moment, to the issue of financing flexibility.

Foothills also takes the position that it should have an increased common equity component in conjunction with its applied-for rate of return on equity, in order that it have the ability to attract an "A" rating from bond rating agencies and enter into bank refinancing under the most desirable circumstances (1T36).

Dr. Sherwin advanced the proposition that, as a matter of fairness, Foothills should be allowed a capital structure which was more consistent with other utilities (6T1015 and 7T1131).

While the Board has heard the evidence of a number of the Foothills' witnesses on the difficulty of being captive to its bank financing, the APMC finds the evidence of Mr. Dooley to be illuminating on the issue of access to financing and Foothills' need for an increased equity component.

Mr. Dooley testified that he did not expect that the current capital structure and

1445
APMC Arg.
(Moreland)

return of 12-1/2 per cent on 25 would, in itself, be sufficient to provide Foothills with an "A" rating. However, Foothills determined that this was not the appropriate year in which to make application for 13 on 35.

He went on to explain that the company did not need an "A" rating this year as its negotiations with the banks would likely not commence this year, and that it had a number of other projects which were under way, so that it was determined that it would be appropriate to apply at a later date (1T38-39).

In the view of the APMC, the Board should give significant weight to the fact that Foothills determined, as a matter of policy, that it did not need the applied-for capital structure and return until it was directed to file an application with the Board.

The Board has also heard evidence that Foothills' relative cost of bank borrowing over time has reduced (1T129ff).

In the submission of the APMC, this fact should be given weight in assessing how Foothills' bankers perceive Foothills' overall risk today, as compared to earlier periods of time.

1446
APMC Arg.
(Moreland)

Foothills has had access to the commercial paper market only since 1985, and first issued commercial paper in 1989. Mr. Dooley testified that the ability of a company to issue commercial paper was evidence that a company was a stronger credit than one which could not access that market (1T131). Furthermore, Foothills' bankers' acceptance rates was renegotiated to more favourable terms in 1990, as you have heard (1T130).

Further, the ability of Foothills' subsidiaries to borrow some $150 million based on their own creditworthiness and on the security of the debentures of the Joint Exploration Company in order to make a non-utility investment in the Joint Exploration Company should also be given serious consideration by the Board when assessing Foothills' ability to access financing (1T82).

Foothills' access to bank financing on reasonable terms, and relatively better terms than in the past, does not appear to the APMC to be consistent with the position that Foothills is in need of a more favourable capital structure treatment today than in the past.

With respect to the proposition that Foothills' needs a 35 per cent deemed common equity

1447
APMC Arg.
(Moreland)

ratio, particularly in order to attract bond financing on reasonable terms, Dr. Waters expressed the view that he did not feel that the markets had been tested to the point where the Board could be satisfied that Foothills in fact needs 35 per cent in order to access bond financing (7T1280ff).

The Company witnesses made general references to an ongoing state of preparedness to position the Company to access bond markets (4T659 and 5T774), but there is no evidence on the record that Foothills has recently made an attempt to access bond financing and has found itself unable to do so, based on its historic 25 per cent deemed common equity component.

The evidence is that the company had, in the past, been advised that a public issue was not saleable. And Mrs. McLeod stated that she had last been involved with a prospective debt issue on behalf of Foothills in approximately 1990 and had not been involved in or aware of others since.

As Dr. Waters indicated, a systematic marketing plan in relation to Foothills' public debt would be necessary in order to undertake bond financing, and the true test of Foothills' need for an increased deemed equity component would be the

1448
APMC Arg.
(Moreland)

reaction of investors to that debt issue (7T1280-81).

Foothills takes the position that it needs a 35 per cent deemed common equity component in order to attract an "A" rating, which is necessary to allow it to access public debt markets and provide it with financing flexibility.

The Board is being asked to give consideration, in that regard, to the pipeline's assessment of what it believes the bond rating agencies will do, which in turn is supposed to be a proxy for an indication of how ultimate investors will behave.

As Dr. Waters has stated, if he were told by the bond rating agencies that 35 per cent was necessary, he would not find that particularly helpful (7T1280).

In the submission of the APMC, the NEB should not find that type of speculation helpful either when determining the fair capital structure and return on equity. The bond raters are not the ultimate investors and, as Dr. Waters pointed out, he is not willing to accept that the basis upon which one should establish capital structure and return is on the basis of, and I quote, "... a

1449
APMC Arg.
(Moreland)

considerable amount of hearsay and undeclared, if any, analysis of what the bond raters have in mind... and the opinions of the investors as to the usefulness of the bond rater's views on these things." (7T1281)

As Dr. Waters indicated, he has recommended a 25 per cent deemed common equity ratio and has incorporated a somewhat higher return on equity into his recommendation, in recognition of the necessary connection between the two concepts, and to allow for the fact that the Board must be cognizant of the fact that Foothills is a private company, thinking about going to market some day (7T1281-82).

The APMC believes that Dr. Waters' position on the appropriate capital structure, when combined with his recommended return, provides a balance between giving the pipeline enough flexibility to access public debt markets and giving the tollpayers the benefit of the lowest cost tolls possible, having regard to the tax implications of increasing the common equity ratio (7T1275).

In summary on this issue, Mr. Chairman, the APMC believes that Foothills has not

established a basis for an increase in the equity component of its capital structure on either the basis of increased business risk or the need for increased equity in order to allow it to finance. On that basis, the APMC urges that the NEB maintain the status quo and permit Foothills 25 per cent deemed common equity in its capital structure.

Perspective on Costs of Capital

I would like now to address, very briefly, the cost of capital perspective, before getting into a discussion of the specific tests that have been utilized in the development of the return on equity recommendations.

In developing the cost of capital perspective. I was reminded of the famous opening sentence from Charles Dickens Tale of Two Cities, and that is: "It was the best of times, it was the worst of times..."

Today's circumstances, Mr. Chairman, are the worst of times -- because as Dr. Sherwin and Ms. McShane told in us their Additional and Rebuttal Evidence, Canada has experienced, over recent years, an unprecedented recession in corporate profitability.

Worse still, perhaps, Dr. Waters

considers prospective business conditions to be bleak and therefore a continuation of the malaise in corporate profitability.

These are the best of times, however, from the perspective of those corporate borrowers and corporations requiring equity financing and having the ability to service their financial obligations comfortably.

Foothills certainly has this ability.

By the historical standards which are closest in memory to most of us here -- that is, the past 20 years -- costs of capital are very low. Both long and short term interest rates, as Mr. Yates told you, in both Canada and the U.S., are at lows last seen in the mid-1970s.

The APMC urges the Board to reflect on these facts and on today's supply and demand conditions in capital markets when considering an appropriate rate of return for Foothills.

Fair Rate of Return

With that backdrop, I would like to deal, now, with the evidence adduced on fair rate of return and indicate, firstly, that some or all of the expert witnesses relied on the following tests: firstly, the Comparable Earnings Test;

secondly, the Discounted Cash Flow; and finally, the Equity Risk Premium Test.

THE COMPARABLE EARNINGS TEST: ITS IRRELEVANCE TODAY

Starting with the Comparable Earnings Test, the heading that I would characterize this under is "Its Irrelevance Today".

At least since the time of Dr. Sherwin's first appearance before this Board, the Comparable Earnings Test has played a very prominent role in rate of return evidence.

Dr. Sherwin has consistently used it and, as you know, Dr. Waters has consistently damned it. The Board has said, on occasion, that it has found the results of the test to have some value.

The APMC submits that it is time to bring down the curtain on the long-running "comparable earnings" show.

Dr. Waters has laid out both the conceptual and practical limitations of the test in his evidence. Dr. Sherwin and Ms. McShane now appear to have conceded that the results of the test, even in their skillful hands, provide no guidance as to a fair rate of return for Foothills, or for any other utility.

1453
APMC Arg.
(Moreland)

Dr. Sherwin and Ms. McShane tell us, at page 4 of their Additional and Reply Evidence, and I quote:

"We have made an attempt at projecting profits for a nine-year cycle (beginning 1992) similar in length to that of the last cycle. While it constitutes our 'best effort', we do not regard the results as sufficiently reliable to provide a basis for utility return awards. Indeed, we view it as unlikely that the current cycle will produce a representative level of returns that may reasonably be expected after the current industrial restructuring is completed and the companies have adjusted to the new international competitive environment.

We therefore have serious doubts that the current cycle will provide a basis for applying the Comparable Earnings Test."

Notwithstanding this clear and -- at least in the eyes of the APMC -- unqualified abandonment of the Comparable Earnings Test,

1454
APMC Arg.
(Moreland)

Dr. Sherwin and Ms. McShane are reluctant to take leave of it entirely. I say that because they give it -- at page 6 of their Additional and Rebuttal Evidence -- 30 per cent weight when they derive their comparable earnings result of 12-1/4 to 12-1/2 per cent.

The attachment to the Comparable Earnings Test appears to result from Dr. Sherwin's view that, and I quote:

"... there will be a successful restructuring in the Canadian [industrial] heartland." (6T943)

Dr. Sherwin's expectation is surely held by everyone who cares about, and has a stake in, Canada's economic future. However, for present purposes, that expectation is nothing more than undoubtedly a very sincerely held view.

The quantification of the expectation is necessary if the test is to play any role in determining a fair rate of return.

Dr. Sherwin and Ms. McShane told you, in the passage that I have just cited to you, that it was impractical to do so. That position was confirmed and emphasized in the course of Mr. Yates' cross-examination on the subject

(6T933-944).

Mr. Chairman, there may well be a time, from Dr. Sherwin and Ms. McShane's perspective, when the Comparable Earnings Test can rise Phoenix-like from the ashes. However, for the time being, in my submission, it should not even be regarded as near terminally ill; it is dead. And it ought not to be relied upon.

Mrs. McLeod also gave some weight (albeit an indeterminate amount of weight) to the Comparable Earnings Test.

She, like Dr. Sherwin and Ms. McShane, provided historical data for the period ending 1992 and projected values for 1993 and 1994 using the IBES (Institutional Brokers Estimation Service) reporting service data.

The comments made by Dr. Sherwin and Ms. McShane concerning the inadequacies of their comparable earnings results are equally applicable to Mrs. McLeod's.

It is also appropriate to mention that, in addition to the infirmities specifically identified by Dr. Sherwin and Ms. McShane, Mrs. McLeod's comparable earning analysis suffers from another defect, and that is that Mrs. McLeod makes

no downward adjustment to reflect the lower risks of Foothills relative to her industrial sample, a matter addressed directly by Dr. Sherwin and Ms. McShane, and, in their view, worthy of a downward adjustment of 30 points (5T820-825 and the Evidence of Dr. Sherwin/Ms. McShane, page A-10).

Finally, Mr. Chairman, on the subject of comparable earnings, it should be mentioned that none of the Foothills' witnesses appears to have given any consideration to the well-known upward bias in the IBES estimates which form the basis for their 1993 and 1994 projections of common equity rates of return.

During cross-examination by Mr. Yates, Dr. Sherwin acknowledged that the IBES estimates had demonstrated a "frailty" since the economic downturn in 1990 (6T941-942); and subsequently, during cross-examination by me, he acknowledged that in the past he and Ms. McShane had made a 40 basis point downward adjustment to the IBES forecasts (6T965). Finally, Ms. McShane acknowledged that in the 1992 Westcoast case she had this to say about the IBES forecasts, and I quote:

"... In the last couple of years there

1457
APMC Arg.
(Moreland)

has been significantly greater disparity between the actual results and the IBES forecasts, and this in large part, I believe, is the result of being in this recession and having the greatest profitability recession this country has known."

In contrast to the detailed knowledge Dr. Sherwin and Ms. McShane have in respect to the IBES forecasts, Ms. McLeod simply and candidly stated, at transcript 819, and I quote: "I do not have a view on that" -- the "that" being the reliability of the IBES forecasts.

In summary, Mr. Chairman, on the Comparable Earnings method, the APMC submits that recent and current earnings levels of industrial companies, together with the vast uncertainties ahead for Canada -- and industrial Canada, in particular -- provide no basis for using it.

Moreover, the results presented for the years 1993 and 1994 by both sets of Foothills' witnesses are clearly upwardly biased.

DISCOUNTED CASH FLOW METHOD

Moving to the DCF method: Dr. Waters and the two sets of Foothills' witnesses all

1458
APMC Arg.
(Moreland)

undertook DCF analyses. However, Dr. Waters concluded that the results which he obtained (which were somewhat below the results for his Equity Risk Premium method) were not suitable for use at this time.

Dr. Sherwin and Ms. McShane did not totally disregard their results, giving them 10 per cent weight (Dr. Sherwin/Ms. McShane Additional and Rebuttal Evidence, page 6).

While Ms. McLeod did not specify the weight that she gave to her DCF results, it had to be rather low, inasmuch as she acknowledged giving primary weight to the Equity Risk Premium Test, the remainder being divided between the DCF and the Comparable Earnings tests.

It is APMC's view that the current applicability of the historical results of both the DCF and Comparable Earnings Tests are highly dependent upon the prospects for growth in corporate earnings.

Dr. Waters has made it clear that those prospects are bleak -- a view that he has consistently put forward to this Board for more than two years, as you know.

Dr. Sherwin acknowledged that the

Consensus Forecasts upon he and Mrs. McShane have relied (although not exclusively) in forming their own forecasts have consistently overestimated growth in economic activity over the past two years (6T933-937).

As discussed earlier, Dr. Sherwin and Ms. McShane also acknowledged, in their Additional and Rebuttal Evidence, the immensity of the uncertanties associated with the future profitability of Canadian industrial corporations.

Mrs. McLeod, on the other hand, acknowledged that ScotiaMcLeod's forecasting record has been both extreme (in relation to other forecasts of other contributors to the Consensus Forecasts) and she has also acknowledged that the ScotiaMcLeod forecasts have been wrong.

In summary, on the witnesses' results from the DCF test, the APMC submits that they should be given no weight. This position stems from the absence of evidence that growth rates in earnings, dividends, and book values, based on several years of historical data, will have a sufficient base of future earnings to provide a meaningful growth in dividends.

Equity Risk Premium Method

Finally on the tests, Mr. Chairman, the Equity Risk Premium method.

As you know, Dr. Waters and both sets

of Foothills' witnesses relied upon the results of their application of this test. Dr. Waters, as you know, relied upon it exclusively; Mrs. McLeod gave it primary weight; and Dr. Sherwin and Ms. McShane gave it 60 per cent weight.

The application of the test by Dr. Waters and Ms. McLeod involved estimates of three parameters:

(i) the base long term Government of Canada bond yield;
(ii) the equity market risk premium; and
(iii) the risk of an investment in Foothills' common equity relative to that in the equity market as a whole.

While Dr. Sherwin and Ms. McShane also used this approach, they added two versions of what they label the "DCF-equity risk premium" test, as well.

(i) The base long term Government of Canada Bond Yield

I would like to talk for a moment about

the base long-term Government of Canada bond yield.

As you have heard, Dr. Waters utilized a range of 7-3/4 to 8-1/4 per cent for the 1993 Test Year. You also heard him indicate, in his updating remarks, that in view of all of the values experienced in 1993 to date and the current level, the likelihood of the range exceeding 8 per cent was extremely low.

Mrs. McLeod, in her Updating Testimony, utilized a rate of 8.2 per cent (McLeod Updating Evidence, Page 1).

This value represented an average of the yields which have materialized to date in 1993 and ScotiaMcLeod's forecast for the remainder of 1993. Those forecasts are 7.85 per cent for the third quarter and 8.40 per cent for the fourth quarter (Schedule 1 of Mrs. McLeod's Updating Evidence).

During cross-examination, Ms. McLeod acknowledged that long term Government of Canada bond yields were in the order of 7.6 per cent at the time of her appearance, and that ScotiaMcLeod had provided forecasts over 1992 and 1993 to date which were consistently upward biased (5T803-809).

Dr. Sherwin and Ms. McShane concluded,

1462
APMC Arg.
(Moreland)

in their Additional and Rebuttal Evidence, at page 3, that an "... average yield of about 8 per cent..." would apply to 1993.

The APMC submits that the Board should conclude that a value of 8 per cent maximum is applicable to 1993. Mrs. McLeod's 8.2 per cent value is upward biased, given the clear bias that has prevailed, both in absolute and relative terms (that is, relative to other forecasting organizations), in ScotiaMcLeod's interest rate and pre-tax profit forecasts.

(ii) The Equity Market Risk Premium

The second of the parameters that were reviewed was the equity market risk premium.

Dr. Waters utilized a value of 4-1/2 per cent maximum. In her Original Evidence, Ms. McLeod appeared to adopt a value of 5 to 7 per cent, although her subsequent computation of the Foothills' risk premium (300 to 350 basis points) suggested that she was probably concentrating on the lower end of that 5 to 7 per cent range (McLeod Evidence, page 43).

In her Response to an NEB IR, Mrs. McLeod adopted a minimum value of 5 per cent for the equity market risk premium. Dr. Sherwin

1463
APMC Arg.
(Moreland)

and Ms. McShane arrived at the values bracketed by Dr. Waters' maximum and Mrs. McLeod's minimum (Evidence of Dr. Sherwin and Ms. McShane, page C-14).

The APMC submits that Dr. Waters' 4-1/2 per cent maximum is the appropriate value. Dr. Waters determined this value on the basis of geometric mean values for the equity risk premiums realized by investors in Canadian equity markets and on long-term Government of Canada bonds over the period 1926 to 1992 and the sub-period 1950 to 1992.

Dr. Waters adopted a value of 4-1/2 per cent because he gave weight, and I quote, "...to the somewhat higher result from the U.S. market over the (1926-1992) period (5.4 per cent) and to the Canadian result of 4.3 per cent for the 1950 to 1992 period..." (Ex. C-1-16, p. 52).

In discussing Dr. Waters' use of historical data in arriving at his estimate of the equity market risk premium, Mr. Lutes made a comment this morning which is best probably characterized as "odd". Mr. Lutes talked about Dr. Waters' "skewing" his results by continuing to update his data; that is, adding more recent years

to his data series.

Mr. Chairman, one is hard put to see why a witness -- particularly an expert witness, relying on statistical analysis of these issues -- should be criticized for providing current data, as current data as possible, particularly when his analysis deals specifically with the implications of those updates, as Dr. Waters' did.

In cross-examination by Mr. Lutes, Dr. Waters was questioned on the fact that he no longer makes an adjustment for two items. The first item was the shortfall between the returns achieved by investors from long term bonds and their prospective yields; the second was the recognition of the purchasing power risk premium.

Dr. Waters made the following comments on this matter in his Evidence, at pages 52 and 53, and I quote:

> "... adding the estimate of 4.5 per cent to the yield on a long-term bond not indexed for inflation (as I do at a later point) could result in an overstatement of the investors' required rate of return for the equity market portfolio. The overstatement

> would be equal to the amount by which the currently required purchasing power risk premium component of long-term bond yields (estimated to be 75-125 basis points) exceeds the sum of two items: (1) the amount contained in achieved rates of return on bonds for having borne this risk and (2) the prospective compensation, if any, required by equity investors for bearing the risk. Estimation of the appropriate amount of both adjustments would be difficult and conditional on a number of contentious assumptions.
>
> Accordingly, I (Dr. Waters) have not made any quantitative allowance for the net purchasing power risk premium in

estimating the Equity Risk Premium for the equity market portfolio."

Having said that, Mr. Chairman, Dr. Waters did not, however, ignore the purchasing power risk premium in arriving at his conclusion as to the reasonableness of the risk premium available to Foothills' owners inherent in his recommended rate of return.

1466
APMC Arg.
(Moreland)

He tells you in his Evidence, at page 53, and I quote:

" I have, however, considered the estimated size of the purchasing power risk premium (75 to 125 basis points) in assessing the risk premium which would be achievable by Foothills' owners if my recommended rate of return were accepted by the Board. The reason for recognizing the purchasing power risk premium at that stage of the analysis is that neither of the two adjustments described above are relevant in this context. The first item (i.e., the amount contained in achieved rates of return for having borne the purchasing power risk) is irrelevant because the context does not involve a historical determination. It simply involves examining what is in store for investors if a particular rate is awarded.

The second item -- prospective compensation, if any, required by equity investors -- is not relevant

1467
APMC Arg.
(Moreland)

because the context is restricted to the prospective premium to Foothills' investors, not equity investors as a whole. Even if the latter were to bear purchasing power risk to some degree and require compensation for so doing, it is not a risk borne by Foothills' owners. The ease and speed with which Foothills' rate of return can be changed with changes in inflationary conditions makes Foothills' rate of return impervious to inflation, for all practical purposes."

A final matter, Mr. Chairman,

concerning the purchasing power risk premium is the two comments made by Dr. Sherwin and Ms. McShane in their Additional and Rebuttal Evidence (page 9-10) with respect to Dr. Waters' estimate of the 75 to 125 basis points for the premium.

Firstly, they conclude there presently exists no purchasing power risk premium in Canadian long term bond yields. They reach this conclusion by matching the most recent "consensus" forecast of long term inflation published in June of 1993 but made as of April of 1993 (As stated by Ms. McLeod

1468
APMC Arg.
(Moreland)

at 5T801) with the yield prevailing in August of 1993.

During that period, the yields on 10-year Government of Canada bonds fell substantially, as shown in Dr. Waters' Evidence at Table 14, which he updated.

Accordingly, what Dr. Sherwin and Mrs. McShane have done is combine an inflation forecast made in April with an August yield. Since the two values are not contemporaneous, there is no basis upon which to arrive at their conclusion.

Dr. Sherwin's and Ms. McShane's second point on this issue is that a "country risk premium" exists against which no utility can be protected.

This may be so, but it is not germane to Dr. Waters' analysis. Nowhere did Dr. Waters make any adjustment to his recommended rate of return for the fact that Canadian long-term bond yields exceeded those for U.S. Treasury bonds. In effect, the incremental return on Canadian bonds is incorporated in the recommended return for Foothills.

(iii) Adjustment for the Relative Risk of Foothills

The third and final parameter in the

1469
APMC Arg.
(Moreland)

development of the Equity Risk Premium is the adjustment for the relative risk of Foothills.

As you know, Dr. Waters utilized a relative risk factor of .5 for his lowest risk utility group.

The result was a risk premium, as you have heard, of 2.25 per cent, to which Dr. Waters added 25 to 50 basis points to compensate for the incremental risks, if any, perceived by investors for an investment in Foothills.

The end result -- that is, a result of 2.5 to 2.75 per cent for Foothills -- is equivalent to viewing it as having a relative risk to the market of .55 to .60 (2.5/4.5 to 2.75/4.5).

Dr. Sherwin and Ms. McShane conclude that the relative risk of Foothills is .7. Together with a 5 per cent market risk premium, this results in an Equity Risk Premium of 3.5 per cent, which they say is to be accompanied by a 35 per cent common equity ratio (Evidence of Dr. Sherwin/Ms. McShane, p. C-16).

Mrs. McLeod, on the other hand, appears to have arrived at a similar conclusion. Her estimate of the Foothills' premium is 3.0 to 3.5 per cent (Mrs. McLeod's Evidence, p. 43).

Dr. Sherwin and Ms. McShane also undertook two analyses which they characterized as "DCF-risk premium tests". The end result of these tests in an estimate of the premium required for a utility.

Dr. Waters has provided a critique of these tests in section 9 of his Evidence. Dr. Sherwin and Ms. McShane provide a spirited rebuttal, at pages 12 to 16 of their Additional and Rebuttal Evidence; and they were cross-examined on these tests at transcript Volume 6 (6T955-964).

Mr. Lutes mentioned this morning that one of the purposes of Dr. Sherwin and Ms. McShane's DCF risk premium tests was to measure the inverse relationship between the level of interest rates and the magnitude of the Equity Risk Premium.

This is, in my submission, a very worthy objective. We hear a great deal about this issue in these proceedings.

Unfortunately, there are many worthy objectives that are not always furtherable by statistical analyses, and unfortunately this is one of them.

Dr. Waters, in his Evidence, in Section

IX, provided a critique of the efforts undertaken by Dr. Sherwin and Ms. McShane on this, and he had the following to say about the matter of the inverse relationship between long-term bond rates and equity risk permium, and I quote:

> "The discussion... of investor tax rates suggests that the relationship between interest rate levels and the size of the Equity Risk Premium, while difficult to estimate is, nevertheless, relatively straightforward.
>
> Recognizing, however, that the implications for the relationship of other factors discussed previously are not straightforward, it would be inappropriate to conclude an inverse relationship will necessarily materialize after appropriate recognition is given to factors such as the purchasing power risk premium.
>
> With respect to reliance upon the results of the historical studies that have been undertaken on the subject, it is prudent to bear in mind that economic relationships are inevitably

> more complex than the empirical models utilized in estimating the relationships. Seldom captured effectively in the empirical models are the effects of the many interdependencies among the explanatory variables. The result is that relationships which appear to be supported by the data from a particular time period are often found to be muted or non-existent in others. It is therefore imperative that the current applicability of any economic relationship which appears to have existed "on average" over some historical period be critically assessed in the context of current circumstances. Otherwise, the happenstance of differences between current circumstances and those prevailing when the estimates were established will, as often as not, lead to inappropriate conclusions."

The APMC submits that the following with respect to the various estimates of the Equity

Risk Premium:

1. Dr. Waters' estimate is clearly conservative, in the sense that it is higher than is necessary. His relative risk factor of 0.5 for his lowest risk utilities is based on five statistical measures of relative share price and earnings volatility. The reasonableness of Dr. Waters' adjustment factor was discussed in his response to Board IR No. 1, Q.63, and augmented by Dr. Waters whilst under cross-examination by Mr. Lutes.

2. APMC submits that, unlike Foothills' witnesses, Dr. Waters did not rely on the historically achieved rates of return on the TSE Utilities Index or the TSE Gas Pipelines Index.

Dr. Waters' reasons for not relying upon such data are given in his evidence, at pages 58 and 59. Basically his position is that "the difficulty with such approach is the tendency for share prices, and hence the achieved rates of return of individual companies and of narrowly defined industry groups to deviate, often for extended periods of time, from the values which would be consistent with their perceived risks".

Mr. Priddle, you may recall that Dr. Waters elaborated upon this difficulty in his response to questioning from you on the final day of the proceeding.

3. The APMC submits that the use of historically achieved risk premiums as a basis for estimating the prospective premium poses problems -- a matter which was discussed again by Dr. Waters in response to your questioning, Mr. Priddle, at Transcript 1183-1185 and following. However, there is a way, albeit not without difficulties of its own, to assess investors' views as to the reasonableness of recommended utility equity risk premiums.

This was discussed by Dr. Waters with Mr. Priddle (7T1286-1288), with particular reference to the awards made to B.C. Gas and Nova Scotia Power within the last 13 months.

4. The DCF risk premium estimates provided by Dr. Sherwin and Ms. McShane suffer from a number of flaws which have been identified in Dr. Waters' critique. (Dr. Waters' evidence, Section 9.) Of particular note is their use in the second DCF study -- that is the new DCF study that they have undertaken -- of a constant 6 per

1475
APMC Arg.
(Moreland)

cent retained earnings growth rate based on a 25-year average.

This morning Mr. Lutes suggested that Dr. Waters' concentration on the item of retained earnings was misplaced because investors look at other indicators of growth.

That may be so. But it is worth pointing out that it was Dr. Sherwin and Ms. McShane, not Dr. Waters, who gave 75 per cent weight, in their DCF study No. 2, to retained earnings growth.

At page 13 of the Additional and Rebuttal Evidence of Dr. Sherwin and Ms. McShane they state that "... the more recent experience probably understates investors' expectations."

There is not, so far as one can tell, any evidence to support this assertion. As discussed by Dr. Waters in his evidence (pages 73-74), the evidence points in the opposite direction, particularly since the growth rate given the greatest weight -- that is, 75 per cent weight -- is a 6 per cent retained earnings growth rate.

5. When all is said and done, the risk premiums which materialize from Dr. Sherwin's and Ms. McShane's analyses for the past six years --

1476
APMC Arg.
(Moreland)

the historical period most comparable to today's interest rate and prospective inflation conditions -- are in the order of the value utilized by Dr. Waters. The average premium from their DCF Study No. 1 for the period 1987 to 1992 is 2.2 per cent, while the average from Study No. 2 is 2.8 per cent. (Evidence of Dr. Sherwin and Ms. McShane, Schedule 17 page 1 and Schedule 19 page 1.) Given the obvious bias in the second study resulting from giving 75 per cent weight to the unchanging 6 per cent retained earnings growth rate, the 2.2 per cent value from Study 1 is the only one which has any merit, in my submission.

Flotation Costs.

The last issue I would like to discuss in respect to return on equity is flotation costs.

The final element entering into the determination of a fair return on equity is the appropriate allowance for the costs of dilution should that be necessary for Foothills to tap financial markets for additional equity capital.

In his Evidence, Dr. Waters indicates that the need for such an allowance is arguable and, in any event, no more than a few basis points

need be added for this purpose. Dr. Waters elaborated upon his position in Response to Board Information Request Number 9 -- and I will not repeat that here.

As you know, Dr. Waters has incorporated a cushion of 25 to 50 basis points in his recommended rate of return, to allow for a variety of uncertainties. The rationale for, and the estimation of, that addition was expanded upon again in response to Board Information Request No. 1, and in response to questioning from Mr. Priddle on the final day of this hearing.

The bottom line is that any need for a protection from dilution is, in my submission, subsumed within the 25 to 50 basis point incremental cushion.

I would like to move, briefly, to the final matters, being, firstly, the Can-Am preliminary costs.

Can-Am Preliminary Costs.

The APMC's interest in pursuing the issue of preliminary costs in relation to the Can-Am project was to satisfy itself that those costs had a direct, or at minimum, an identifiable and sufficient nexus to the project which was

eventually undertaken for the benefit of the Foothills' system.

The concern arose from the fact that the costs incurred were in respect to preliminary studies and a pipeline application relating to a project other than the project which eventually proceeded.

The APMC's concern about the connection between the incurrence of these costs and the degree of system benefit is not -- and I hope

Mr. Pierce will be gratified to hear -- indicative of a policy on the part of the Government of Alberta that it is opposed to Foothills pursuing new projects which will expand its pipeline. The APMC's concern is that, prior to having those costs placed into rate base, the Pipeline be able to establish, to the satisfaction of the Board and Interested Parties, who are entitled to test these matters, that there is a reasonable and sufficient connection between the costs incurred and the eventual expansion.

The company indicated, through Mr. Pierce, that "out of almost every project, you learn something that will help you somewhere else" (3T481).

In the view of the APMC, the inclusion of preliminary costs into rate base should only take place if something more tangible is established, and the company can establish how the work undertaken has been utilized in the ultimate project.

Foothills was prepared to indicate that in its view all of the costs incurred and studies undertaken in respect to the Can-Am project resulted in the final facilities which were constructed (3T479-80).

On the basis of Foothills' assurance that all of the costs incurred resulted in the final project being constructed, the APMC does not oppose the inclusion of the costs in rate base, but would echo the position expressed by Mr. Yates this morning on behalf of CAPP -- that "it", the APMC -- trusts that the Board will examine these costs carefully.

The APMC does remain concerned about the accounting treatment of the Can-Am related costs since Foothills was directed by the Board to defer the amount into Account 172 in 1985.

Foothills has been earning, as you have heard, a return and charging a tax expense in

respect to this amount (1T143).

Pursuant to the Gas Pipeline Accounting Regulations, it appears to the APMC that balances in Account 172 are intended to be deferred, and can be brought forward either for inclusion into plant accounts in the event a project proceeds, or booked as an income deduction in the event the project does not proceed. The APMC requests that the NEB clarify whether or not Foothills has been entitled to collect return and associated tax expense in respect to the deferred amount, as Foothills suggests.

Deferred Tax

Briefly on the issue of deferred tax, the APMC, like CAPP, is in the position of seeking a raincheck on the determination of the deferred tax issue in this proceeding.

The APMC and CAPP received relevant deferred tax information late in this process as a result of the Board directing Foothills to file a response to APMC-CAPP Information Requests 25.4 and 25.6.

The APMC appreciates the fact that Foothills' deferred tax balance comprises a significant component of Foothills' rate base

relative to the Westcoast and TransCanada systems.

As a result of the relatively large magnitude of the deferred tax balance, the need to further evaluate the information received, in consultation with experts, and the desire that Foothills be given an opportunity to discuss the impact of drawdown with its financiers, the APMC requests that the Board not make a determination on this issue at this time, but does request that Foothills be directed to report to the Board and Interested Parties the outcome of discussions it has with its lenders related to the financing implications of various drawdown scenarios.

Application of IROR

Very briefly in respect to the application of the IROR: the APMC supports the request made by Foothills that the IROR not apply to expansion facilities added to its system since the original line was placed into service. The APMC supports the position taken by Foothills on the legal basis upon which the Board can grant that request as well, and I will not add anything to what Mr. Lutes told you this morning.

Reasons for Decision.

Finally, Mr. Chairman, as indicated in

the evidence of the APMC, it urges the Board to provide Reasons for Decision in respect of this proceeding which are as comprehensive as possible.

As Mr. Priddle observed, perhaps the development of a body of evidence and the crafting of a decision in this process will help to facilitate settlements in the future (4T634).

Along with the body of evidence which has been generated through the process, the APMC believes that clear and detailed findings on the matters in issue in this process are critical to the facilitation of future negotiations.

Foothills expressed some frustration with CAPP in attempting to resolve these issues short of the hearing process (4T624ff).

Mr. Chairman, the APMC was also engaged in those discussions, and believes that, with full and complete Reasons from the Board, and a more free flow of information, such as the deferred tax material which was provided in response to the Board's direction, the negotiation process (which I think we are all attempting to advocate and promote) could only be improved in the future.

Sir, those are my remarks on behalf of the APMC, subject to any questions that you might

1483

have.

THE CHAIRMAN: Thank you, Ms. Moreland. The Board has no questions.

MS. MORELAND: Thank you, Mr. Chairman.

MR. LUTES: Mr. Chairman, if there are no other parties who wish to argue, we would like to have the opportunity to present a very brief reply argument. If it would be acceptable to the Board to adjourn until two o'clock, we could probably count on being done in 30 minutes to 45 minutes.

THE CHAIRMAN: That is quite acceptable, Mr. Lutes.

MR. LUTES: Thank you, Mr. Chairman.

THE CHAIRMAN: We will adjourn now and reconvene at two o'clock.

-- Luncheon recess

--- Upon Resuming

MR. LUTES: Good afternoon, Mr. Chairman.

THE CHAIRMAN: Good afternoon, Mr. Lutes.

MR. LUTES: If there are no preliminary matters, Mr. Chairman, I will commence Foothills' Reply Argument.

THE CHAIRMAN: Please proceed, Mr. Lutes.

REPLY ARGUMENT ON BEHALF OF FOOTHILLS PIPE LINES LTD.:

MR. LUTES: Mr. Chairman, listening to my friend's arguments this morning, we continue to hear the argument that somehow the Prebuild Project gets some special protection from the risks that other gas exporters have to absorb, and these are, broadly speaking, in the form of these assurances and these guarantees.

I would like to ask you to do this: In your own minds, you have got to accept that the fact that Mr. Yates says that that is the case does not make it so. CAPP and APMC have not demonstrated any practical effect that these so-called assurances and guarantees will have for

Foothills, as it now faces all of the risks of the marketplace.

The assurances and guarantees did ease the transition that Foothills had to go through in the marketplace, but they have in no way affected the outcome of the changes that have taken place.

And again, he referenced Order 380 and the exemption that Foothills' customers received.

Yes, Northwest Alasakan's Tariff was exempted from the impact of 380. But the interstate pipelines customers were impacted. Those customers were relieved of their obligations, and the interstate pipeline customers could not perform their obligations to Northwest Alaska.

Why did we have the force majeure claims by United? Just ask yourselves.

There is not one concrete example offered by CAPP or APMC about how Foothills business risks will be different today as a result of those assurances.

In fact, Mr. Yates should have listened to my cross-examination. I cross-examined Mr. Nettleton about Order 256, and I read to Mr. Nettleton about Order 256-A.

Mr. Yates said to you this morning: And

1486
FHPL Reply Arg.
(Lutes)

unlike other Canadian gas exporters, Foothills got exempted from the impact of Order 256.

Order 256-A clearly stated that Order 256 did not apply to Canadian gas exports. But for the special assurances, the sales by Northwest Alasakan would have been impacted by Order 256.

So the only thing that happened in that regard was that, at the end of the day, Foothills ended up where all of the other Canadian gas export pipelines ended up, insofar as Order 256 was concerned.

Let me make a few comments about the eclectic use of the load factors and the volumes.

In 1983, we had low load factors. In 1984, we had low load factors. In 1985, we had low load factors. In 1992, we have high load factors.

Ms. Moreland and Mr. Yates equate the condition of our business today, the condition typified by today's high load factor, with Foothills business risks. There is no comparison and no necessary correlation between today's condition and the business risks which Foothills faces.

Just go back to square one. In 1980, Foothills had back-to-back contracts with large

1487
FHPL Reply Arg.
(Lutes)

interstate gas pipeline buyers. Those buyers were permitted to roll-in the high cost of Canadian gas with their gas supply, which had a generally lower cost. And that was permitted by regulatory order. And the third thing that the Project had is it had the assurance that there would be no regulatory interference with those arrangements.

We all know that the market conditions which existed in the 1980s, in the early 1980s, resulted in low load factors. But despite the low load factors, Foothills never once failed to recover its demand charges.

Why didn't Foothills fail, or why did Foothills recover its demand charges in the face of those low load factors?

It was because of the existence of the back-to-back contracts, the roll-in of those costs by the interstate pipelines, and no regulatory intervention that enabled those pipelines to pay the demand charges.

If those circumstances reoccurred today, who would pay the demand charges?

There is no interstate pipeline standing down there to pay the demand charges and then roll them into their costs.

The load factors are a red herring. None of our shippers today have the ability to pay our demand charges and then roll those costs into some other form of revenue collection. That is the difference. That is what has happened.

Now you say: You are operating at a 90-percent load factor today.

Again, that is today's business condition. The only thing that we know for sure is that things will change tomorrow -- and the changes may be good and the changes may be bad. But circumstances can arise in the marketplace which can adversely affect the ability of Alberta gas producers to market gas in those markets. That can happen. And when it happens, we won't have United, or Panhandle, or Northern Natural to pay the demand charges and roll them into their costs. We will have to manage our own problems.

Mr. Yates says: Our tolls are lower now than they were, and Foothills transportation contracts are longer.

Okay. We agree with that. The tolls may be lower, but we are still the highest cost transporter into every market that the gas on our system enters. The price of gas is lower today

FHPL Reply Arg.
(Lutes)

than it was in 1980, and 1981, and 1982.

So again, it is eclectic thought. But lower...? It has to mean something in the context of the risks that we are talking about. It has to mean something in the context of the delivered cost of gas into the market and the price that the gas commands and what the competition is in that market.

Our contracts may be longer. They may be longer. But in 1980, Foothills was protected by contracts and downstream arrangements which extended for the entire depreciation life of the asset.

You will remember that earlier in my argument this morning I mentioned that it was a condition imposed on the financing of the Project that the loans be self-liquidating over the life of project.

It does not matter that the contracts may be slightly longer today. By comparison to what existed in 1980, it did not matter, and it does not matter.

Mr. Yates did something very interesting this morning. He did not even make a pretense of trying to deal with our arguments about

FHPL Reply Arg.
(Lutes)

our comparative risks. He blew by TransCanada; he did not talk about Westcoast; and he did not talk about ANG. Instead, he pulled out of the hat TQM.

That surprised us, and it surprises me now, because there is not much on the record about TQM. There were a couple of Information Requests, I think, from the Board.

But we do know some things about TQM, and I will start by saying that I think that TQM is the least comparable pipeline to Foothills, of all the pipelines.

TQM has one shipper with a long-term contract, and TransCanada is that one shipper, and TransCanada is one of the largest and most-powerful companies in this country.

And despite only having one shipper, with one contract, with one of the largest companies in Canada, TQM is only a Triple-B credit.

You know, when I thought about the TQM argument, it reminded me of something else Mr. Yates said: Foothills has more shippers today than it did in 1980, and it is, therefore, less risky.

And I thought: Gee, I read a couple of

1491
FHPL Reply Arg.
(Lutes)

Press Releases last week. Last Friday TQM issued a Press Release, and said that Olympia & York Developments had contracted for 50 per cent of the capacity on the TQM system, and TransCanada had relinquished that capacity. And on Monday I read another Press Release. It was from CAPP, and it stated: "Now that TQM has diversified its shipper base, CAPP will be applying to the National Energy Board to reduce its equity ratio, because its risks are lower."

That is the type of logic that permeates the whole CAPP/APMC position: Foothills has more shippers; ergo, it is less risky.

You cannot conclude that. I am not going to repeat why. It should be as obvious to Mr. Yates why you cannot conclude that as it is to me, and I hope it is to you.

He makes the comparison of TQM having TransCanada as a shipper, and he says "Just like Foothills has NOVA as a shipper in Zone 6".

Well, I don't know where he was during the cross-examination of our witnesses, but I thought it was him -- and if it was not him, it was someone else. We made it very clear. He did acknowledge that NOVA had short-term arrangements,

1492
FHPL Reply Arg.
(Lutes)

relatively short term.

But the evidence is absolutely clear: yes, NOVA is the shipper on Zone 6. But on the Pan-Alberta volumes, they have a one-year arrangement. And any time they elect on one-year's notice, they are gone, and we are back to the original arrangement. And on the balance of the volumes, they have a four-year arrangement.

And of the 600 million a day that NOVA ships that goes to TransCanada, I assume half that gas goes to the export market, just as half of TransCanada's gas goes to the export market.

There is no significant relationship between Foothills business risks in the export market and the fact that NOVA ships 600 million a day over and above the Zone 9 volumes to TransCanada.

One of the arguments that was made by Ms. Moreland -- and we heard this during Board Counsel's examination -- is that gas delivered on Foothills into the U.S. Midwest accesses all of the Lower 48 states.

I don't know whether that is so or not, and I am not sure that the record is clear on whether that is so. But accepting that it is, I am

not sure what one is to conclude from that.

Does the fact that gas shipped on the Prebuild into the Midwest has to be sold in 48 states make Foothills less risky than, for example, the gas which TransCanada sells under long-term contracts into one market in the U.S. Northeast?

I think not. I think not.

We do know that gas is sold mainly into spot markets, and I assume the reason it is sold in so many states is that it does not have a home. It has to be sold in a lot of states, and it has to bear the additional incremental costs of transportation in moving out of the Northwest into all the states in which it is sold.

One would think that, given the fact that Foothills is already the high cost transporter into the U.S. Midwest, it would follow that that gas, as it moves into other markets beyond the U.S. Midwest, pays incremental tolls.

So how competitive is it?

You cannot conclude that Foothills is less risky than the other Canadian gas exporters because its gas is sold in 48 states. That would lead me to conclude it is more risky.

One of the things we heard this morning

(Lutes)

is that Foothills did not seek a change in its common equity ratio in 1984 and 1986. Mr. Yates also said that we were prepared to continue with the existing tolls in 1993 and that, despite that, we now need a 40 per cent increase in the equity ratio.

I think I dealt, in part, with why we were here and why this is the right time to do what has to be done with respect to the capital structure of this company, today. I did that this morning. But I have some comments on the arguments that have been made.

Firstly, we are quite happy to be here. We are quite happy to have this matter dealt with. I think it is fair to say that had we not been brought into this proceeding as a result of CAPP's Complaint in the spring of this year, we would have been here on our own volition in 1994.

Having said that, let me deal with the 1984/1986 argument.

One only has to look at what Foothills tolls were in 1984 and 1986 and the conditions that it was facing with respect to United and the other purchasers, and the difficulty which its shippers were having moving gas into those markets and

1495
FHPL Reply Arg.
(Lutes)

restructuring their arrangements, to understand why Foothills and its Management elected not to seek higher equity ratios during that period of time.

Instead, Foothills satisfied its higher risk through seeking higher equity returns. And in both 1984 and 1986, the Board recognized the higher risks and provided an incremental return on common equity.

We were advised by our advisors to seek an increase in our equity ratio. Foothills chose not to. We do not think the fact that we chose not to seek higher equity ratios in 1984 and 1986, or 1988, or 1990, or even until we were forced into this proceeding in 1993, is any argument which would indicate that we are not entitled to have the business risks of this Company fully recognized in determining what the appropriate equity ratio is.

We are not here today, as we have in the past, seeking an incremental equity return. We now choose to have you consider our equity ratio in the context of our business risks.

Mr. Chairman, the argument is made that we are inconsistent because we argue we need to be competitive and yet we now seek a higher equity ratio.

I think our witnesses answered that question during the cross-examination. But besides, if you accept that argument, then Foothills could never seek an increase in its tolls for any reason.

We have described to you, in some detail, why we think it is now appropriate to increase the equity ratio. We think the steps we have taken over the last two or three years -- with the expansion, with the move to flow-through income taxes, with the lower depreciation rates, and, frankly, the rather sharp decline in our tolls that has resulted from those steps -- now make it an appropriate time to consider this matter.

Mr. Yates argues that the fact that we were able to renegotiate our loan agreements in 1990 and reduce the bank spreads on those loans is evidence that we are financeable. And both he and Ms. Moreland say: Foothills is in the commercial paper market, and only low-risk industrial companies are permitted into the commercial paper market.

What they should have said was: Only low-risk industrial companies and banks are permitted into the commercial paper market --

because the evidence was absolutely clear that the only basis that Foothills has to access the commercial paper market is that its commercial paper is fully guaranteed by its bank line.

The commercial paper program is part of the Bank Loan Agreement. It is an option available to Foothills under the original loan agreements. And any time Foothills chooses, it can draw down on the bank loan to redeem the commercial paper.

Foothills access to the commercial paper market is not evidence of Foothills stand-alone financeability. It is evidence that the banks can access commercial paper markets.

How about the renegotiation and the lower spreads?

I think there are a couple of things you should keep in mind when we talk about renegotiating those loans. The renegotiations involved a number of things, including an extension of the basket clause, the depreciation rates, and all of the other items that go into the Bank Loan Agreement.

Significantly, one of the things that Foothills was not seeking was any new money. So what you were dealing with was a bank lender who

already had his money in the ground -- sort of sunk costs. And the banks had as much concern as Foothills did at that time towards taking steps to make the pipeline more competitive and improving the marketability of gas flowing through the project.

If you were the lenders to this project, you would not want to end up owning a pipeline that was itself not economic. So the banks had their own self-interest at stake.

And you cannot conclude, Mr. Chairman, that because Foothills was able to get lower spreads, they saw the pipeline as any less risky.

I think Mr. Nattress' Evidence is quite clear that it was our view that the spreads contained in the original agreement were too high and, in effect, unfair to Foothills.

And at the end of the day, why did the banks renegotiate the depreciation rates and extend the term of the basket clauses?

I think the answer is obvious, if you think about it. The basket clauses are like a ticking bomb, if you will. Banks don't want to trigger the basket clauses. Nobody knows what would happen if we depreciated the remaining assets

over the next four years. Would any of this gas be marketable?

The fact that we were able to renegotiate the bank loans has more to do with the fact that the banks are into the project. It reminds me of the old saying: "If you owe your banker a $1,000, you've got a problem, if you owe him $1 million, he's got a problem."

The Banks are in the project, for better or for worse -- and we were not seeking any new money.

The next thing I want to deal with is the Joint Exploration Company.

I am surprised that Mr. Yates would make -- and if I mischaracterize what he said this morning, I apologize, and I apologize to him now.

As I understood him this morning, he said that Foothills' ability to borrow $150 million for the Joint Exploration Company was evidence that Foothills is financeable.

And I am surprised that he would say that, given Mr. Dooley's evidence. And I would like to read it, because I think this is important. It is important to understand what this transaction was all about, because it is a red

herring; and it is important because I think it characterizes APMC's and CAPP's position in this proceeding.

To me, it shows that they have played fast and loose with the facts.

Here is what Mr. Dooley says:

"By way of clarification, on that point with respect to the Joint Exploration Company, this, as I pointed out yesterday, was an arrangement that was made completely outside of the cost of service arrangements and the debt was borrowed in subsidiaries that were separate from our cost of service operating subsidiaries; and that debt was recoursed only, as Mr. Nattress has pointed out, to the debenture issued by the Joint Exploration Company.

That debenture, in turn, was fully guaranteed as to principal and interest by the major shareholder in the Joint Exploration Company, which is a substantial Canadian publicly-traded corporation that has investment grade credit ratings.

There was an inference yesterday -- in fact, I was not in a position yesterday to disclose who that company was. I felt that I had an obligation to the Management of it not to bring it into a public forum without their being advised of it and being comfortable with it.

That company is Cameco Corporation, which was formed as an amalgamation of the former Eldorado Nuclear and the Saskatchewan Mining Development Corporation. It has a partner on the other side of it."

Mr. Chairman, clearly, the transaction of which he speaks was secured by a debenture issued by the Joint Venture Exploration Company and guaranteed by a company who has credit in the marketplace.

Mr. Chairman, Foothills takes strong objection to the implication in Mr. Yates' argument that somehow this transaction was inappropriate or underhanded, or that it was somehow colouring our view of the appropriate treatment of the deferred income tax pool, or in fact of our responsibility

to our shippers or to the Board.

To the extent that any of Foothills money was invested in this Project, it was for the account of Foothills' shareholders -- and their investment was a legitimate and appropriate business transaction for them to undertake.

Let me say something about the CAN-AM costs. I heard Ms. Moreland question the accounting treatment for these costs.

These costs were recorded in a rate base account, and the accounting treatment, including the earning of return on these costs, is consistent with the treatment accorded rate base accounts in both the Board's accounting rules and in Foothills' Tariff.

Foothills has a specific Tariff provision by which this account properly recorded these expenditures, and by which return was appropriately earned on them.

In that regard, these expenditures are treated no differently than other expenditures on projects under way which earn AFUDC until they are transferred to rate base.

There was nothing unusual or which could be characterized as inappropriate, or in any

1503
FHPL Reply Arg.
(Lutes)

way wrong with respect to the treatment of these costs.

The implication that they should not have been allowed to earn a rate of return is totally inappropriate. The moneys were spent. They would have earned AFUDC, or they would have been transferred to rate base, and there they always would have earned a return.

Mr. Chairman, I want to make a few comments on Ms. Moreland's remarks on the Comparable Earnings evidence of Dr. Sherwin and Ms. McShane, and as well upon the use given to the IBES data.

At page 4 of Dr. Sherwin's Supplemental Evidence, which is in Exhibit B-10, he says this:

"It may be recalled that the comparable earnings test serves as a fairness standard, not a measure of the cost of attracting capital. Cynics may say that this fairness standard has become a fair weather standard. Such a claim would have no merit.

All standards (or techniques) for measuring the fair return rest on the premise that their applicability is

1504
FHPL Reply Arg.
(Lutes)

dependent on the presence of normal or representative conditions.

When interest rates rose close to the 20% level in in the early 1980s, no Board accepted those levels as a norm for setting utility returns.

Similarly now, a prolonged industrial profit depression does not provide a standard for utility returns. An averaging of such depressed levels with the high levels of returns earned in earlier years would, only by coincidence, produce a reliable estimate of a normal prospective level of profit."

That is the end of the quotation.

I think the suggestion that the Comparable Earnings Test is dead may be a bit premature. It is far from dead. It is still the face-on test of the "fairness" standard. Dr. Sherwin continues to accord 30 per cent weight to its results.

We do not accept Ms. Moreland's characterization of the evidence of Dr. Sherwin in this case.

1505
FHPL Reply Arg.
(Lutes)

I am not going to read to you what Dr. Sherwin says about the results of the Comparable Earnings Test and the impact of the IBES projected growth in earnings on that test; but I am going to say to you that I think she has mischaracterized for you what weight Dr. Sherwin puts on those IBES results.

I think Dr. Sherwin and Ms. McShane know full well, and have factored into their use of the Comparable Earnings Test, the fact that the results of the IBES forecasts may be less than accurate.

And I draw your attention to the bottom of page 5, where, after discussing the impact of the IBES results on the Comparable Earnings Test, Dr. Sherwin and Ms. McShane say, and I quote:

"These projections are highly speculative; their principal merit lies in demonstrating that the current cycle is unlikely to be representative of a "normal" earnings level..."

And he goes on.

He knows, and Ms. McShane knows, that the results are influenced by the IBES forecasts and are highly speculative. Those have already

1506
FHPL Reply Arg.
(Lutes)

been built-in to his recommendation in this case.

Just two general comments before I conclude.

Mr. Yates started this morning by saying that "CAPP's approach to these proceedings is balanced; that it has the best interests of the pipelines at heart; and that CAPP is not in an adversarial position".

He may say that, Mr. Chairman -- but that is not Foothills' perception of the real world. We believe that CAPP, unlike our shippers, does and has taken in the past an adversarial approach. We believe that CAPP is not concerned with Foothills financial integrity or fairness to its shareholders; we believe that CAPP is concerned only with lower tolls.

And one other comment. Because of the time that we had available to us, it was not possible to review the quotations which Ms. Moreland referred to in her argument this morning. We take exception to a number of the quotations and the way they were used.

And because we have not had time to go to the transcripts to read the quotations and the context in which those quotations were given, we

rely on the Board to ensure that the quotations which were used in Ms. Moreland's argument this morning have accurately reflected the positions that were taken at those places in the transcript where they were taken from.

With that, Mr. Chairman, that concludes our reply comments, unless there are any questions.

THE CHAIRMAN: Thank you, Mr. Lutes.

Mr. Priddle, please.

MR. PRIDDLE: Mr. Lutes, could you just remind me as to what, if anything, the banks presently have in their hands by way of assignments of contractual arrangements from Foothills or Foothills shippers?

MR. LUTES: Mr. Priddle, perhaps I should start by saying that this morning I may have left you with the impression that United remains committed to its transportation arrangements with Northern Border.

I was reminded that that is not accurate; that to the extent that United volumes were taken over by Pan-Alberta's U.S. subsidiary, 100 million a day of those volumes -- which were taken by Northern Natural -- have Northern Natural's commitment to Northern Border attached to

them. The Panhandle volumes, at least as far as

Northern Border is concerned, continue to be secured by Panhandle's guarantee. But Northern Border does not have the assurances of United with respect to the remaining 350 million a day that Pan-Alberta Gas (U.S.) moves of the original United volumes.

Having said that, I am not exactly certain of the extent of the downstream arrangements. I understand, and it is my belief, that the arrangements which exist between Pan-Alberta Gas Ltd. on this side of the border selling to Northwest Alasakan at the border, who then resells to Pan-Alberta Gas (U.S.), are now the subject of the security assignment.

So, in fact, it is Pan-Alberta Gas (U.S.) which is the U.S. buyer, and the contracts upstream are assigned through us to the banks.

And of course, on the West Leg, the original PITCO arrangements remain in place.

MR. PRIDDLE: Is anything else assigned to the banks? Is there anything assigned in respect of the PGT-II expansion, shipper contracts on PGT-II?

MR. LUTES: The expansion

financing -- and this is a point I overlooked this morning. Mr. Yates said, this morning, that Foothills has successfully financed the expansion of Zone 8.

That, of course, is incorrect. The Zone 8 construction financing, a temporary short-term loan, has been obtained. At the present time, that loan is secured by the guarantees of Alberta Natural Gas and Foothills Pipe Lines Ltd.

And until the actual financing of the expansion is undertaken with the banks, the final security arrangements have not been settled. In fact, it may not be financed with the banks.

At this time, only the construction financing is in place for the expansion, and the security for that has been provided by the parents.

MR. PRIDDLE: Thank you.

THE CHAIRMAN: Thank you, Mr. Lutes.

I would like to thank you and all other counsel and witnesses for their appearance here;

also, I would like to thank Board Counsel and Board
staff.

The Board reserves its Decision on this
matter, and this Hearing is adjourned.
--- The Hearing Closed

RH-1-93 - Volume 8

Index for all transcripts / Indice des transcriptions d'audiences
Index for this transcript / Indice de la présente transcription d'audience
previous volume précédent
next volume suivant